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ECONOMIC STABILITY IN THE POST-WAR WORLD

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THE CONDITIONS OF PROSPERITY AFTER
THE TRANSITION FROM WAR TO PEACE

Report of the Delegation on Economic Depressions

Part II



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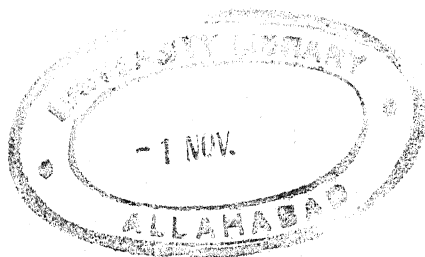
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PREFACE

As is stated in the Preface to Part I of this Report,¹ the Assembly of the League of Nations instructed the Economic and Financial Organization of the League in October 1937 to consider the measures that might be employed "for preventing or mitigating economic depressions"; and a Delegation, of which we are members, was appointed to prepare a report on this subject.

Our work was interrupted by the outbreak of war; and, in view of the rapid changes both in economic conditions and in public opinion on economic questions caused by the war, it was not until 1943 that it seemed advisable for us to resume our meetings. In the meantime, however, the Economic, Financial and Transit Department of the League had conducted a series of studies on post-war economic problems which greatly facilitated our work and enabled us to issue the first Part of our Report in April 1943 under the title "The Transition from War to Peace Economy". In this first Part we endeavoured to trace the broad lines of policy which in our opinion governments should pursue in order to effect as smooth and as rapid a transition as possible from war to peace economy.

In the present, final, Part of our Report we are concerned with the longer-term problem of securing economic stability and the fullest possible use of productive resources, once those resources have been effectively readapted to peacetime requirements.

We greatly regret to have to record the death of two members of our Delegation, Sir Frederick Phillips, who had acted since our first meeting in 1938 as our Chairman, and Dr. G. H. C. Hart, only recently appointed to replace another member. With the authorization of the President of the Council of the League of Nations, Mr. Costa Da Rels, the Hon. R. H. Brand and Dr. D. Crena de Iongh have been appointed to fill these vacancies in our membership which have so unhappily arisen.

The Delegation, in addition to its meetings in 1938, 1939 and 1943, has held five sessions between October 1944 and February 1945 at Princeton, New Jersey. The members of the Delegation serve in their individual capacity and not as representatives of

¹ League of Nations, *The Transition from War to Peace Economy: Report of the Delegation on Economic Depressions, Part I* (League of Nations, 1943. II. A. 3).

governments; certain members, while accepting the report as a whole as being a valuable contribution to the understanding of the problems with which it deals, must, in view of the official positions which they hold, put themselves on record as not being identified with every specific measure proposed or discussed therein. The meetings at Princeton devoted to this second Part of our Report were attended by the following members or their substitutes:

Mr. W. W. Riefler (Chairman),
 The Honourable R. H. Brand, C.M.G.,
 Mr. W. Domaniewski (replacing Mr. Z. Karpinski),
 Professor Carter Goodrich (representing the International Development Works Committee of the International Labour Organization),
 Dr. D. Crena de Iongh,
 Mr. F. L. McDougall, C.M.G.,
 Mr. R. Marjolin (replacing Mr. Z. Karpinski),
 Professor Oskar Morgenstern,
 Mr. Louis Rasminsky (replacing Mr. G. F. Towers),
 Mr. G. F. Towers, C.M.G.

We were fortunate enough to be able to benefit, also, from the valuable assistance at all our meetings of Professor G. Haberler; and we have had the advantage of the attendance at our meetings of experts of the International Labour Office. Finally, the Delegation wishes to record its warm appreciation of the contributions made by Dr. Alexander Loveday and the officials of the Economic, Financial and Transit Department of the League, without whom, indeed, the Report could not have been prepared.

February 12th, 1945

INTRODUCTION

1. THE NATURE OF THE PROBLEM BEFORE US

We are concerned here with the long-term problem of cyclical fluctuations in economic activity, and not with the special causes of instability in the immediate post-war period of transition from war to peace economy, which we have discussed in Part I. of our Report.¹ At no moment of time, however, will it be possible to state that the transition period is closed and that economic life and organization have assumed their peacetime form. Nor will the effects of the present war ever have completely exhausted themselves. We are concerned therefore with a world which will be widely different from what we have known in the past, and a world still bearing the brutal marks of long years of warfare. But we shall assume a situation in which the productive forces are once more mainly devoted to the preparation and distribution of goods required for civilian production, in which demobilization has been successfully effected, and the long-term factors of instability which have characterized the economic history of the last century and a half or more are once again as influential as any factors born of the war period.

This, like the preceding Part of our Report, owes much to the past work of the Economic, Financial and Transit Department of the League on business cycle analysis, in particular to that of Professors G. Haberler² and J. Tinbergen.³ In "Prosperity and Depression", Professor Haberler has critically surveyed and classified the whole field of business cycle theory. He found certain important differences of opinion among various writers concerning the causes and causal relationships, but about the general mechanism, "a much greater harmony . . . than the superficial observer would believe or even than these same writers would be willing to admit". Certain of the theories classified by Professor Haberler were later subjected to statistical tests by Professor Tinbergen, and the re-

¹ League of Nations, *The Transition from War to Peace Economy: Report of the Delegation on Economic Depressions, Part I* (League of Nations, 1943. II. A. 3).

² Gottfried Haberler, *Prosperity and Depression: A Theoretical Analysis of Cyclical Movements* (League of Nations, Geneva, 1939. II. A. 4(1): Third Edition, enlarged by Part III, Geneva, 1941).

³ J. Tinbergen, *The Statistical Testing of Business Cycle Theory* (League of Nations, Geneva): Vol. I, *A Method and its Application to Investment Activity* (1938. II. A. 23); Vol. II, *Business Cycles in the United States of America, 1919-1932* (1939. II. A. 16).

sults of Professor Tinbergen's work suggested not only that there may be differences of opinion about the causes of business cycles, but that individual cyclical movements may in fact have different causes. But these differences do not necessarily imply equivalent differences in the means of prevention or cure. We shall, however, have to distinguish between different types of depressions for which different policies may be required. A state of depression, unemployment and reduced production may be the result of the current ebb of business activity associated with the investment cycles; or it may be the result of structural maladjustments, the failure of particular countries or industries to adapt themselves to deep-seated changes in demand or supply conditions; or it may be the result of exceptional forces extraneous to the economic system affected. Since we began our work the greatest of all extraneous forces, war, has again affected the whole world. History shows that depressions which occur in the first decade or more after major wars tend to be of exceptional violence and duration. We have to face, therefore, the probability of depressions occurring owing to any or all of these three types of causes and that at least certain of these causes will prove to be of exceptional virulence.

There is a growing measure of agreement among economists and politicians about the most important means of prevention and cure. It is our aim to crystallize this consensus of opinion. But, important as this evolution of opinion is, we have to face the fact that governments had not before the present war recognized any definite obligation to maintain a high and stable level of employment. We are forced, therefore, to draw conclusions based rather on the present state of thought and theory on this subject than on practical experience of the successful execution of anti-depression policies. We have no doubt that when these theories are tested in the crucible of history some will require modification, some adaptation to unforeseen conditions, and that some new theories will have to be evolved.

2. THE INTERNATIONAL ASPECTS OF THE PROBLEM

A great deal of the discussion which has taken place has been confined to the problems of a single country and has tended to ignore the international implications of the anti-depression policies that might be pursued by that country. Although we cannot

ignore local or partial depressions, our major concern is with those fluctuations in business activity which spread from country to country and tend to affect the whole world. We have, therefore, to consider not only the policies which might be adopted in the major industrial countries, in which we believe depressions are usually generated, but those appropriate for less developed economies, and, above all, those concerted international policies and instruments by which the spread of depressions may be controlled and checked.

We wish to draw special attention to the international aspects of this whole problem; for there is in our opinion a danger that governments, inspired by the desire to maintain a high level of employment at home in all circumstances, may pursue policies which not only give rise to unemployment elsewhere, but, by blocking the channels of trade, or obstructing the productive transfer of funds, will retard economic progress both at home and abroad. Cyclical fluctuations in business activity in an economically integrated world are not a national but an international phenomenon, and require not only national but international action.

The history of the last pre-war decade affords more than adequate proof of the truth of this fact. The Great Depression which began in 1929 had left no part of the world untouched. Everywhere, though in varying degrees, it levied its toll; men without work while machines were idle and raw materials were in glut; poverty, want, destitution; the moral and psychological frustration of enforced idleness. By 1938, when we began our work, most countries had emerged from the depths of depression reached in the early 'thirties, and national economic activity in most parts of the world was at a higher level than in 1932 or 1933. But in large and important areas there remained great numbers of workers unemployed, and this unemployment was to a considerable extent the natural effect of the breakdown of international economic relations which resulted from the first measures of uncoordinated national defence against the onslaught of the depression.

Moreover, these measures were in no small degree responsible for the weakening of the fabric of international economic relationships, the virtual breakdown of the international economic system. In the situation of mass unemployment and mass poverty which developed in the Great Depression, it would have been morally im-

possible for the governments of the world to have stood idly by and to have waited for "natural economic forces" to cure the situation, even if such a negative policy had been intellectually defensible. In the event, each government took separate steps to alleviate distress and to revive agriculture and industry within its own frontiers—steps that varied with the means at the disposal of each state, with the prevailing social and economic philosophies and with the current diagnosis of the nature of the economic ills afflicting the community. But in thus describing what was done we probably exaggerate the extent to which the measures adopted in dealing with the depression were in fact part of systematic and coherent policies. As often as not, these measures were merely expedients imposed by the pressure of events and directed towards an immediate and visible objective—the succouring of a group particularly hard hit, the bolstering-up of a tottering financial structure.

The most striking fact which emerged from the Delegation's first examination in 1938 and 1939 of the measures which different countries have adopted in attempting to deal with the Great Depression was the extent to which these measures (if based on any theory at all) were based on the concept of a limited market both in the international and in the domestic field. Attention was concentrated mainly on the division of the market as between nationals and foreigners and as between competing groups of nationals. The possibilities of general expansion were not fully explored; and sight was largely lost of the fact that a greater share of a contracting market may be less than a smaller share of an expanding market. In the international field the policies adopted in consequence of this view—for example, tariffs, quotas, multiple currency practices, exchange controls, subsidization of exports—like the depression itself, inevitably contributed to the fractionalization of the world economic system and were of a type which aggravated the economic difficulties of other countries.

So far as certain of the smaller countries were concerned, the restrictive measures that were adopted in the decade preceding the outbreak of war were the reflex and necessary counterpart of other measures to promote internal recovery designed to raise the purchasing power of particular sections of their communities. Lacking adequate international reserves, the balance of payments

position of these smaller countries forced them to seek the shelter of restrictive controls for their domestic recovery measures. In the aggregate, these actions helped to shatter the weakened fabric of world economic relationships.

But the economically more powerful countries, although they had less reason to be concerned with the risk of their reserves becoming depleted, contributed no less, through the policies they adopted, to the disruption of the economic system under which the world had previously operated. For they, too, proceeded to restrict imports by raising tariffs, by fixing quotas or by devaluing their currencies—and this in spite of the special responsibility for maintaining general economic activity that the size of their markets imposed on them.

In so far as the explanation of these policies is to be found in economic phenomena—and political conditions undoubtedly played their important part—it would seem to lie in the fact that there was at that time no agreed opinion about the measures by which it would be possible to overcome a depression as deep as that with which the world was confronted at that time. All those governments which did in fact adopt constructive measures were experimenting; and there was little hope that a common view concerning which experiments were likely to prove successful could have been formulated. In the absence of any agreed principles of action, it was natural that through such machinery as existed for securing joint and co-ordinated policies it proved impossible to resolve the problems with which statesmen were beset. But there was in reality no unavoidable conflict between the natural preoccupations of each country with its volume of employment or level of income on the one hand, and the healthy functioning of the international economic system on the other. It would have been as feasible for countries to have adopted anti-depression policies from which all would have benefited if adopted in unison, as it was for them to adopt policies which, when generalized, injured all. What was lacking was a knowledge of the appropriate measures with which to overcome the depression, a preconcerted system for the uniform application of such policies, and sufficiently powerful international agencies such as those now proposed, which might on their own initiative have contributed to recovery. In default of a common philosophy and in default of these necessary instruments

of policy, the will to act jointly could not develop. Moreover, action urgently required and imperatively demanded by the great mass of the people so tragically affected by the depression could not wait for the evolution of a doctrine or the construction of an international mechanism; hence, governments resorted almost blindly to a policy of "sauve qui peut".

The main strand of thought which has run through the work of the Delegation since its inception has been that so long as national economic policies are based on fear and not on confidence and mutual aid they are bound to be essentially negative, restrictive, self-destructive. Fear of war was no doubt the greatest deterrent to the pursuit of rational economic policies; and we have insisted, in the body of our Report, that a sense of political security is an indispensable prerequisite to the achievement of economic stability with a high standard of living. But even if the fear of war is eliminated, there is a grave danger that economic policies which are based upon another fear—that of unemployment—will be defensive and anti-social in character. What is required is the substitution of positive for negative aims—not the relief of unemployment when it develops, but the attainment of high and stable levels of output and employment in keeping with the capacity of industry and agriculture; not the protection of particular interests against foreign competition, but the encouragement of general expansion.

The economic distortions produced by the war will undoubtedly make the attainment of the objectives of policy which we have set ourselves more difficult. On the other hand, the war itself has provided the most striking possible demonstration of what can be accomplished by national policies directed towards common and positive aims. The main task before us is to adopt positive peacetime objectives and to pursue these objectives with the same driving force, the same inner compulsion as have prevailed during the war.

There are fortunately good grounds for hoping that governments will take a broader view and adopt more courageous policies in the future; for not only have a number of governments formally expressed their determination to maintain a high and stable level of employment at home, but in their recent declarations the United Nations have repeatedly insisted on the need for more

effective international economic collaboration than we experienced in the inter-war period.

3. GENERAL OBJECTIVES OF POLICY

We have drawn attention in the Introduction to Part I of our Report to the changes that have been taking place during the war in public opinion on economic questions—the belief that we should think in terms of consumers' needs first, and then in terms of our mechanical, scientific, and human power to satisfy those needs, the belief that wide differences in the standards of living of different peoples are a menace to social order and international understanding, the growing sense of world unity. These changes are affecting the generally accepted objectives of economic policy today and must affect the tenor of our reasoning and our recommendations. In order to make clear, therefore, the considerations which we have had in mind when formulating the proposals which we make later, we repeat here the summary of the objectives of policy set out in our earlier introduction.

We believe that the objectives of economic policy should be to assure:

“1) that the fullest possible use is made of the resources of production, human and material, of the skill and enterprise of the individual, of available scientific discoveries and inventions, so as to attain and maintain in all countries a stable economy and rising standards of living;

2) that, in so far as possible, no man or woman able and willing to work should be unable to obtain employment for periods of time longer than is needed to transfer from one occupation to another or, when necessary, to acquire a new skill;

3) that in the use of these productive resources, the provision of goods and service to meet the essential physiological needs of all classes of the population in food, clothing, house room and medical care, is a prime consideration;

4) that society distribute, as far as possible, the risk to the individual resulting from interruption or reduction of earning power;

5) that the liberty of each individual to choose his own occupation is respected and is promoted by more nearly equal educational opportunities;

6) that the liberty of each country to share in the markets of the world and thus to obtain access to the raw materials and manufactured goods bought and sold on those markets is promoted by the progressive removal of obstructions to trade;

7) that the benefits of modern methods of production are made available to all peoples both by the progressive removal of obstructions to trade and by courageous international measures of reconstruction and development."¹

What is required is not only a high level of employment, but efficient employment. Policy must be concerned not only with the size of the national income, but also with its distribution, must aim not only at reducing the risk of unemployment, but also at an equitable sharing of its burden. It must be designed to promote the welfare not of some nations only, but of all, and to assure the smooth working of the economic system without impairing essential human liberties.

4. THE IMPORTANCE OF SOUND TRANSITION POLICIES

As we have stated, this Part of our Report is not concerned with the transition period, with which we dealt at length in Part I; indeed, we assume throughout this volume that the problems of the transition have been successfully overcome, and address ourselves here exclusively to the longer-term problem of securing economic stability and the fullest possible use of productive resources. But it is our duty to emphasize again that the immediate problem is that of the transition period; the method of dealing with this period is likely to determine the character of economic policy for decades to come. The danger is that the policies followed, particularly in the field of international action, will not be commensurate with the magnitude of the problem, and that concerted policies will not be worked out nor the institutions necessary to give effect to them established before the emergencies of the transition are upon us.

It is a matter of the utmost urgency that agreement among governments on the matters we have mentioned should be reached soon, so that the machinery will be in functioning order when the emergency does arise. If this is not done, it seems inevitable that the *ad hoc* uncoordinated decisions of individual governments to

¹ *The Transition from War to Peace Economy* (League of Nations), p. 14.

deal with specific problems confronting them at that time (whether these problems relate to import controls, surplus stocks of commodities, or exchange control practices) will be of a defensive rather than of an expansive character, and that these defensive policies embarked on in the transition period will set the tone of international economic policy for a long period to come. We would also urge that in the approach to these problems the guiding spirit should be that which actuated governments in adhering to the general principles of the Atlantic Charter and Article VII of the Mutual Aid Agreements. Short-run considerations of expediency may from time to time appear to indicate a temporizing approach; the immediate difficulties of bold action may make the temporizing approach appear to be more realistic than a bold and far-sighted view. Realism is, however, not to be confused with myopia.

The world has learnt much in recent years about the means by which active economic conditions may be maintained. If we fail to attack the transition problems boldly, if we make a bad start after the war, the cause will lie, therefore, rather in lack of purpose than in lack of knowledge. The history of recent years demonstrates that it is only by concerted action among nations, conceived in terms of a realistic recognition of the mutual dependence of one country's prosperity on that of its neighbours, that any enduring policies of economic stability can be worked out. If we fail again to work out these policies, if we repeat the economic history of the 1930's, it will not be so much because we are in doubt as to the right policies, as because at the time when greatness and vision were called for we failed to measure up. The history of the past generation has been a history largely of temporizing and makeshift expedients. Let us hope that this dark chapter will soon be finally closed. The Delegation does not underrate the difficulties of a co-operative effort; but the alternative has been tried, with results only too apparent. The only genuinely realistic and practical view is that the co-operative effort, notwithstanding its difficulties, must now be made to work.

Indeed, the major challenge for democratic statesmen and administrators after this war will be that of maximizing material wealth without jeopardizing human liberties. That is the goal of statesmanship, and we with our more limited task of proposing measures to prevent any slackening in the progress towards that

goal must keep this challenge constantly in mind. It does not fall within our competence to suggest means by which all the factors of production may be so marshalled as to maximize production, or to advise upon the innumerable technical and scientific problems that present themselves. Our task is to suggest means by which the general mechanism of the whole economic system may continue to function without halt or hindrance. We should fail to meet our responsibility were we to underestimate or belittle the difficulty.

5. THE STRUCTURE OF OUR REPORT

Owing to the complexity of the problem with which we have to deal, we have thought it desirable to preface our consideration of policy by a Section setting out the nature and mechanism of depressions in industrial and other states and the structural changes which the world is undergoing. The second Section deals with policy, and at the end of this second Section we have added a chapter summarizing our conclusions. We have endeavoured in this summary to throw into relief those conclusions which seem to us to be of major importance. But in practice policies must always be adapted to the circumstances of the moment; on one occasion one, on another occasion another instrument of policy may be the more appropriate. While it is hoped, therefore, that this final chapter may prove of value as a guide, it should not be read without reference to the earlier chapters on which it is based.

Section I.

The Nature of Depressions

CHAPTER I

STRUCTURAL FACTORS

The ebb and flow of business, which we now characterize as the business cycle, take place in a given economic environment of institutions and habits. These tide-like movements appear to be an inherent characteristic of an individualistic economy and to be related to the process of capital accumulation and economic progress under that system. In more primitive societies they find their partial counterpart in lean and fat years, in the alternation of abundance and famine.

Progress in individualist economies has not taken the form of a steady uphill climb to new levels of output and well-being, but has been marked by successive spurts and halts, by alternations of periods of prosperity and depression. Each successive spurt differs in some ways from its predecessors; new paths are explored and fresh ground broken. Similarly the periods of arrested advance differ. But all periods of prosperity or of depression have certain characteristics in common. The former are marked by a rapid accumulation of real capital (investment by producers and consumers in durable goods) and of working stocks, associated with a general rise in incomes and demand; while periods of depression are marked by a sharp decline in the output of capital goods and in working stocks, associated with a general contraction of incomes and of demand.

As industrialization progresses and a greater proportion of the total productive forces of any country is devoted to the manufacture of capital goods, the instability of the economic system increases, depressions are liable to become more intense and the risk of unemployment becomes more serious.

Certain indirect effects of this industrialization accentuate the tendency to instability. Amongst those of particular importance are the effects of the slowing up of the rate of population growth

which seems to accompany the process of urbanization, and the changes in demand to which increased wealth due to industrialization gives rise.

1. DEMOGRAPHIC INFLUENCES

The first effect of the increased wealth and productivity in Western Europe, which was associated with the revolutionary technical developments and accumulation of capital in the last century, was an unprecedented increase in population. The improvement in health associated with the rising standard of living led to a spectacular decline in the death rate and consequent sharp increase in populations in the advanced industrial countries during the major part of the 19th Century.¹ But this fall in death rates was accompanied or preceded by a fall in birth rates in industrial countries, the movement beginning in France as early as 1830, in Scandinavia and England after 1890, and in Germany, the Netherlands and Czechoslovakia after the turn of the century. Since 1910 the downward movement has been greatly accelerated and has been spreading since the last war to the industrial areas of North America, Oceania and elsewhere. In almost all highly urbanized countries the rate of population growth has in consequence flattened out, and declining population is to be foreseen if the anticipated excess of deaths over births is not made good by immigration. The following estimates for certain European countries, which do not include the effects of the present war, are characteristic.

TABLE I
Past and Future Population Trends in Advanced Industrial Countries
Total Population (000,000's)

	1914	1940	Projections ²					
			1945	1950	1955	1960	1965	1970
United Kingdom and Ireland	46.1	50.2	50.6	50.6	50.2	49.4	48.2	46.8
Sweden	5.7	6.33	6.38	6.37	6.31	6.21	6.05	5.84
Czechoslovakia	...	15.3	15.5	15.6	15.6	15.5	15.2	14.9
Germany	67.8	69.5	71.2	72.0	72.2	71.8	71.1	69.8
Belgium	7.7	8.31	8.35	8.34	8.27	8.16	7.98	7.76
France	39.8	41.2	40.8	40.3	39.7	39.0	38.1	36.9
Tot. 6(5) countries	167.1	190.8	192.8	193.2	192.3	190.1	186.6	182.0

¹ Cf. *Final Report of The Mixed Committee of the League of Nations on the Relation of Nutrition to Health, Agriculture and Economic Policy* (League of Nations, 1937. II. A. 10), London, 1937, Chap. II.

² *The Future Population of Europe and the Soviet Union* (League of Nations, 1944, II, A. 2), pp. 56 and 75.

The rapid expansion of population during the nineteenth century probably helped to maintain active employment. Such an expansion gives rise to a relatively steady and persistent growth in the demand for such commodities of basic necessity as food and clothing, and the increase in the number of families provides a steady demand for new houses and all the durable goods (furniture, domestic appliances, etc.) connected with the setting up of a home. Other types of investment, particularly schools, but roads, railways, and public utilities as well, are also related to the growth of population and increase steadily with population. At the same time an expanding population renders the economic system more adaptable to change. The labour force is younger and able more easily to learn new skills, and important shifts in demand and production can be met largely by a change in the flow of new recruits into industry instead of by the more difficult process of shifting those already employed.

A slowing up of population growth or a declining population affects employment and stability in precisely the opposite way. Certain types of investment opportunities—those particularly related to the number of households and to the size of the population—decline; the working population becomes older and less adaptable, while changing demands may involve shifting workers out of existing industries, with inevitable transfer frictions and unemployment. A retardation of population growth, moreover, renders consumers' demand more unstable. For with a smaller proportion of children in the population the demand for immediately consumable and indispensable goods such as food and clothing becomes relatively less important, and the demand for luxury or semi-luxury goods, more important. This latter demand can be and is postponed when times are bad, and is, moreover, peculiarly subject to changes in fashion and taste. A retardation of population growth thus has effects similar to those of an increase in national income in countries already relatively rich, and indeed is likely to be accompanied by or give rise to an increase in income per head.

2. INCREASE IN INCOME PER HEAD

Of the luxury and semi-luxury goods, some are durable—automobiles, refrigerators, wireless sets, etc.; others, though less durable, are subject to capricious changes of fashion; still others

consist of services, such as entertainment or travel. The essential feature of the demand for all goods of this class is that it is less stable or dependable than the demand for basic articles of food, dress, and housing; the automobile can be made to last another year; it is possible to get along with a smaller wardrobe; the holiday can be postponed until times improve.

The growing importance of this postponable and unstable personal consumption is an inevitable accompaniment to a rising standard of living. A wealthy community is more subject to the type of economic instability we have in mind than is a needy community, though it will be in a better position to weather bad times because it has reserves to fall back on.

3. INCREASED IMPORTANCE OF CAPITAL GOODS

The effect of the increasing instability of consumers' demand is reinforced by the growing proportion of the national income of richer countries which is saved and devoted to the production of capital goods. It is mainly this process of saving and investment which makes countries richer and renders labour more productive by providing it with more and better technical equipment. But the process of investment, in an individualist economy, is extremely unstable. It can cease altogether if the profit outlook seems dark, and in time of depression even gives way to capital consumption, the existing equipment not even being maintained.

Thus the increased relative importance of capital goods in total production tends (like the increased importance of durable and luxury goods in total consumption) to increase the instability of the economic system, while at the same time it also increases its dynamic power and renders possible a higher level of satisfaction. When the business outlook darkens, or when there is some slackening in consumers' demand, businessmen will tend to stop buying new machinery and plant and will satisfy demand with the existing plant. The more important the industries making plant, *i.e.*, the capital-goods industries, the greater is the danger of a contraction in the demand for plant upsetting general economic activity.

The general point made in the last few paragraphs has been succinctly stated¹ as follows:

¹ A. Loveday, *Problems of Economic Insecurity*, in "The World's Economic Future". Halley Stewart Lectures, 1937 (London 1938).

"Demand may be looked upon as appertaining to a series of overlapping groups of goods and services, with absolute necessities at one end of the scale and new capital goods at the other; between these two we find conventional necessities, goods satisfying secondary needs, luxuries, etc. At each step demand becomes less and less stable. There is a physiological check to the contraction of the demand for food, there are conventional checks to the contraction of the demand for other goods, conventional checks which become weaker and weaker the more durable the goods are. The demand for plant may fall to zero. . . . The more total demand and consequently total productive resources are devoted to satisfying needs which are not considered of first necessity, the greater the possible contraction of demand and of productive activity, the more serious our depressions are likely to be."

In the immediate post-war years, however, there will be in certain countries a very great demand for savings to rebuild the capital that has been destroyed during the war and to make up for the normal investment which had to be postponed during the war years. But when the reconstruction period is over, while savings may remain high or even grow with the restoration and increase of national wealth, opportunities for further investment at the intense reconstruction rate may well not prove to be available. Unless special steps are taken to increase consumption demand, or provide new investment opportunities either at home or abroad, serious unemployment may ensue in the investment industries, spreading to the consumption goods industries and involving the whole economy in a general depression.

4. THE CHANGING DISTRIBUTION OF INCOME

In most advanced industrial states and in many others as well, the distribution of income during the present century has been rendered more even both by measures designed to relieve poverty, such as health and unemployment insurance, old age and widows' pensions, subsidies to consumers, etc., and by the application of progressive scales in direct taxation. In so far as these measures result either in maintaining demand in bad times, as does, for instance, unemployment insurance, or in increasing the proportion of the national income spent upon necessities, they have a stabilizing effect, which must be set against the tendency towards greater instability that we have mentioned in the last three sections.

On the other hand, unless met by suitable institutional adjustments, very steep gearing of taxes may tend to check progress by

reducing the large personal incomes from which a considerable proportion of risk-bearing capital has been derived in the past and by narrowing the spread between the net return on funds put out at risk and funds maintained in relatively liquid form. We shall revert to this point in a later chapter, and would only observe here that different types of taxation may be required in highly advanced countries where the elements of instability are serious and in less developed countries where rapid progress is likely to be a primary consideration.

5. GROWTH OF RIGIDITIES

While demand has been tending to become increasingly capricious, unpredictable and volatile, the productive process itself has become subject to increasing rigidities. The modern economic system imposes the need for great adjustments—and weakens the capacity to make them. Groups with great financial or political power—cartels, trusts, labour unions—have acquired monopolistic or semi-monopolistic control of important sectors of the economic system; and this control is sometimes exercised in ways detrimental to economic stability.

For it is a condition of stability that the economic system should be able to adapt itself smoothly and without any great friction to changes in demand and supply conditions, in technique and in invention. Changes in relative prices which alter the relative profitability of different lines of production constitute the process by which this adaptation is encouraged. Certain non-institutional factors, such as the increased importance of fixed capital, renders adaptation more difficult than previously; fixed capital cannot suddenly be re-invested in a different form to accommodate a change in demand. But more important have been the factors interfering, through organized control, with the formation of prices and preventing relative prices from accurately reflecting the demand for different classes of products and services. Concentration of control of a large portion of the output of important industries in the hands of a few producers, frequently behind high customs tariffs, has enabled them to pursue an independent price policy. To the extent to which they keep the prices of their products rigid when demand wanes they will tend to reduce demand still more, and throw more men out of work. In some countries

agricultural interests have been strong enough to keep agricultural prices, through protection, quite out of line with the rest of the world, and have prevented adjustments where adjustments were required. At the same time, the trade unions have rendered certain wage rates less elastic than in the nineteenth century and have reduced the mobility of labour both from occupation to occupation and from place to place.

In consequence of these developments there grew up in certain countries during the inter-war period a price system which was half free and half flexible—in some parts of the economic system decreases in demand resulted primarily in price reductions, while in other parts they resulted primarily in a contraction of output and the maintenance of prices. While again no categorical statement about the effects of the present war can be made, the available evidence and the trend of present day politico-economic thought in most countries give no grounds for assuming that there will not be an extension of the range of relatively rigid prices. It seems likely, also, that there may be a wide extension in many countries of both state control of trade and state trading; and the concentration of demand in government hands during the war inevitably gives rise to closer co-operation between producers in each industry and may tend later to the formation of producers' agreements, cartels, etc. Moreover, the application of more scientific methods in production encourages the concentration of producers into larger units for the conduct of research.

Rigidity in certain of the elements entering into costs tends to throw the burden of price adjustments on others, and thus to increase the price changes to which these others are subjected. It would, however, be dangerous to conclude dogmatically that greater all-round flexibility of prices and costs would necessarily make depressions less severe. The essence of the question is the effect of such flexibility on total purchasing power and demand, and there are factors operating in both directions. On the one hand, the restoration of profitable cost-price relationships through a reduction of costs which are out of line tends to stimulate investment and so to increase purchasing power. But if cost-reductions set up anticipations of further cost and price reductions, producers may restrict their purchases and wait until prices are lower. If a general reduction in wages leads to a decline in the purchasing

power of the working classes, entrepreneurs' profit anticipations may be adversely affected and, in spite of the fact that their liquid position is improved through the reduction in wage disbursements, they may be less willing than they were before the wage reduction to use their liquid balances and credit resources to replace plant and to produce. In these circumstances there would be a net contraction of purchasing power and a deepening of the depression.

It is not possible to say *a priori* which of these conflicting tendencies will be stronger. Similarly in the case of monopolistic producers of goods no generalization seems possible. If monopolistic producers keep prices high during periods when there is a contraction of demand and income, and if they hoard their monopolistic profits, this clearly aggravates the depression. But monopolists do not necessarily act in this way; sometimes, indeed, they adjust their prices to the state of economic activity more rapidly than competitive producers are able to do.

6. GROWTH OF STATE INTERVENTION

If we examine the economic evolution of the last century we shall find that it has led inevitably to the assumption by the state of greater responsibilities in the direction of economic life and to the general acceptance of the view today that the state has a direct obligation to prevent serious depressions to the best of its ability, or, if they occur, to take measures to overcome them. The demands of a modern wealthy society are more dispensable, more postponable, than they were; they are less firmly supported by the needs for such simple things as food and clothing of the coming generation; they no longer expand automatically along foreseeable lines as population expands, but spread and ramify, start forward violently and violently contract. Demand was formerly met mainly by individuals or small firms conducting a competitive struggle for existence, with high economic mortality, and, through the process of evolutionary elimination, adapting themselves to the changes in demand that resulted from the slow swings of taste or from the gradual growth of income per head as total national production outran the expansion of population. As demand has become more varied, the unit of production has grown and become less adaptable. The automatic elimination of surplus or inappropriate capital equipment is no longer possible by the old evolutionary means.

Adaptation on the scale required by the normal changes of habit and wealth can only be effected by the deliberate action of the large firm. Much of the waste of the old ruthless system may be avoided. But if these large undertakings fail to make the necessary adjustments, then progress may be seriously impeded and depressions may develop into violent crises. Intervention by the state may be indispensable to assure that adjustments are effected, and similarly intervention by the state may be required to prevent the collapse of some large enterprise which would lead to widespread disaster.

In practice the role of the state in most countries has become much wider than that of an impartial director of traffic or umpire in the conduct of business. The state has itself acquired control of many of the largest undertakings or natural monopolies, has substituted public for private monopoly, and has frequently entered the field of foreign commerce not simply to determine the rules of the game, but to participate in it itself. These centralized powers may be used in such a way as to maintain economic stability or in such a way as to increase rigidities and international instability. They afford an opportunity but also involve a risk.

7. ECONOMIC EFFECTS OF WARS

(a) *General.*

Up to this point we have been discussing long-term tendencies which have continued over many decades. Some of these tendencies have been accelerated and some temporarily checked by the most important of all factors of instability, namely, war. Wars have always intensified the amplitude of cyclical fluctuations, magnifying both the height of booms and the depth of depressions.

It is not necessary to repeat here the description given in Part I of our Report (on the transition from war to peace economy)¹ of the immediate structural economic problems arising out of the present war. It is enough to recall some of the main headings: the destruction, consumption, and non-replacement of capital equipment and stocks; the changes in the international debtor-creditor position; the concentration of plant and skills in war

¹ *The Transition from War to Peace Economy: Report of the Delegation on Economic Depressions, Part I* (League of Nations, 1943. II. A. 3). In subsequent pages, for brevity this is referred to as "the first Part (or "Part I") of our Report".

industries, much of which will prove redundant after the war; the backlog of consumers' demand for durable and semi-durable goods and the stored-up savings which will be available to make this demand effective; the depredations and currency inflation in occupied countries in Europe and Asia; the suspension of normal channels of international trade and investment; autarkic developments and the abnormal growth of industries producing substitute materials.

We believe that if the policies suggested in the first Part of our Report¹ are adopted, many of the post-war factors of instability may be successfully resisted or compensated. But many of these factors will not be and cannot be eliminated; they are too deeply imbedded in the fears and hatreds bred of war; or they represent weaknesses in the economic structure which cannot readily be repaired. Time and regrowth alone can effect the final cure. We must accept the fact that even when the transition period has merged into a new post-war era of progressive development, the present war will still render the task of governments in maintaining economic stability more difficult. At the best we can but hope that it will have strengthened the will to face the task.

Countries which have been at war twice in a generation will be reluctant to reopen normal commercial relations with their enemies; men and women who have lost their savings through war havoc or inflation twice in a generation may be reluctant to save. The profound changes which the war has wrought in the relative economic strength and levels of living of different peoples cannot be made good in any brief span of time. The world will have lost its old balance and will not quickly find a new one. Indeed it never found a steady balance in the inter-war period; the nearest it came to so doing was probably during the period of greatest general momentum between 1925 and 1927. If after this war world economic activity can re-acquire momentum, the chances of establishing an equilibrium will be greatly increased, and the rising standards of living to which this momentum will give rise will go far to overcome the special difficulties of adjustment, especially in agriculture.

¹ *The Transition from War to Peace Economy: Report of the Delegation on Economic Depressions, Part I* (League of Nations, 1943. II. A. 3).

(b) Agricultural Maladjustment.

During the last war agriculture on the continent of Europe became so disorganized that almost two years after the armistice the area under cereals was still 15 per cent lower than it had been before the outbreak of war, a loss of 12,000,000 hectares. On the North American Continent it had risen by 16 per cent, 14,000,000 hectares.¹ Gradually and painfully order was restored in Europe and land was got back into cultivation; the need for the overseas supplies, which had been increased to meet the war requirements of the allies and with a view to the post-war needs of Europe, diminished—cereal productive capacity became excessive. The inevitable pressure on world markets was accentuated on the one hand by the technical progress in the West, the growing mechanization of agriculture, the development of new strains of wheat, etc., and on the other hand, after 1926, by the imposition of higher tariffs in Europe and by the reduction in the cereal consumption per head of the Western European peoples.

The case of sugar is typical. During the 1914-18 war, European beet production fell by two-thirds, but cane production in Cuba increased rapidly. From 1923-25 there was a rapid revival of production in Europe, assisted by tariffs and bounties, accompanied by further cane plantings overseas because the European increase had not been foreseen. In Java a new variety of cane gave a 30 per cent greater yield. Hence, from 1925, prices obtained by exporters were unprofitable, and little progress had been made in finding alternative production for the distressed areas when the depression in 1929 caused a further serious deterioration in their position. The price per lb. of raw sugar was about $\frac{1}{2}$ d. in 1930, compared with $1\frac{1}{4}$ d. in 1925 and 2d. in 1923.

That history is repeating itself today. We do not know exactly what the acreage or production in Europe has been; but cereal harvests on the Continent have fallen substantially since 1939, while in North America the acreage under the plough is increasing. Up to date the increase has been less rapid than it was on the last occasion, and the larger crops harvested since 1939 have been due in great part to favourable weather conditions. But with the ad-

¹ In 1919 the area was still greater—17,000,000 ha. in excess of the average of the pre-war quinquennium.

vance of science each acre represents a greater productive capacity. A similar problem of adaptation will recur. It will not arise at once after the war, if adequate steps are taken to meet the needs of the peoples who are suffering abnormal deprivation today; but it will arise unless there is a radical change not only in agricultural but in nutritional and general economic policies.

It is not our purpose in this chapter to suggest solutions; nor are we concerned in this Part of our Report with the post-war transition period. We should, however, run the risk of exaggerating the danger of agricultural overproduction were we to fail to draw attention at once to the fact that if stable employment can be maintained in great industrial centres and genuine efforts are made to maintain the standard of nutrition even if employment shrinks, the problem of adaptation may become one largely of choice between types of production rather than of the curtailment of production. But the tendency for agricultural population to diminish will, we believe, continue in any case. There are no grounds for assuming that the historical trend, the inevitable result of the development of scientific methods of production, will be arrested, and whatever economic or nutritional policies may be, that trend is likely to be accelerated in certain regions by the war-time expansion of industrially produced raw materials.

(c) *Changes in Sources and Uses of Raw Materials.*

Wool and cotton are likely to feel increasingly the pressure of the competition of artificial fibres in the future, though the effects of that pressure may be more gradual and less dramatic than the effects of rayon and nylon on the silk industry. As scientific discoveries multiply, the cost of producing synthetic rubber will inevitably fall. The plastic industry to which, like the synthetic rubber industry, the war is giving an extraordinary stimulus is still in its infancy and will compete with a constantly increasing range both of agricultural and mineral products; the elaboration of new processes, such as the utilization of magnesium for aeroplane construction, and the expansion of plants for processing certain minerals, such as bauxite, will profoundly modify both the relative demand for different classes of raw materials and the relative supply. A long period of adaptation must be foreseen. During this period of adaptation certain areas and the producers of cer-

tain products are likely to suffer; forces arising out of structural changes and conducive at least to partial depression are likely to make themselves felt. In the end the relative importance both of different classes of raw materials and of different geographical areas will present a picture widely different from that known in the past.

(d) *Geographical Shifts in Industrial Development.*

Concurrently with the changes in the geographical distribution of agricultural production referred to above, there has occurred during the past generation a wide diffusion of industry throughout the world. Although the industrialization of agricultural countries was hastened by agricultural protection of their former customers, it is natural and indeed inevitable that such states should gradually develop their own industries. The former concentration of manufacturing production in a small area in Northwestern Europe and the Eastern United States was associated with proximity to sources of power and also with the existence of a consuming market large enough to permit of specialization; historical reasons such as the freedom of the United Kingdom from war on its own territory also played an important part. With the export of capital from these rich manufacturing centres, the industrially less advanced countries developed their own machine industries, this process being facilitated by the emergence of oil and electricity as sources of power, which made the localization of industry less dependent upon the presence of coal deposits. The development of automatic machinery dispensed to a large extent with the need for certain traditional types of skilled labour; and the mechanical skill required in handling the machinery was rapidly developed in the newly industrialized countries.

Before the last war the adjustments required by the spread of manufacturing production appear, on the whole, to have been successfully made. But the problem was greatly aggravated during the war and post-war years. Restrictions on shipping and on certain types of production in belligerent countries gave a strong fillip to the development of certain industries outside Europe. For certain industrial products, world excess capacity became common when the industries of the belligerent countries were released from war employment. Nationalistic economic policies aggravated the

situation after the war, and during the Great Depression low prices of primary products and foreign exchange difficulties stimulated the desire of agricultural and mining states to diversify their production. Efforts to combat the depression by expanding purchasing power also contributed to this end by creating a domestic demand which made it profitable to establish local manufacturing industries in certain non-industrialized states. Moreover, rapidly increasing population in certain of these countries involved an increase in the economies of manufacture; while the temporary decline in world demand for primary products resulted in an unemployed agricultural proletariat which was partly absorbed by the establishment of manufacturing industries in the towns.

The extent to which this tendency for new industrial countries to develop was accelerated after the Depression of 1929 can be simply illustrated by a comparison of the movements of their indices of industrial production with those of the older industrial countries.

TABLE II
Indices of Industrial Production—Averages for 1936-38
(1929 = 100)

<i>Old Industrial Countries</i>		<i>New Industrial Countries</i>	
France	79	Poland	106
Belgium	88	New Zealand	130
United States	93	Chile	131
Germany	115	Finland	150
United Kingdom	118	Greece	152
Sweden	146	Japan	165

These percentage figures give an exaggerated impression of the development in the new countries, as the quantities involved were still very much smaller than in the old industrial countries. Nonetheless, the task of adjustment required of the export industries in the older countries was very severe; and in some of them the inability to make the adjustment proved an important cause of localized depression and unemployment.

During the present war this process of industrialization in countries previously dependent mainly on agriculture and mining has continued in some cases at an accelerated rate, while the older industrial countries in Europe have lost through actual destruction, transfer to Germany, or wear and tear varying proportions of their mechanical equipment. It is too early to attempt to assess

these losses or the gains of countries in other continents. The situation when the war ends will, however, certainly differ greatly from that which presented itself in 1918 in one important respect. During the last war the greatest expansion took place in the consumers' goods industries outside the United States and Europe; but though striking in one or two countries, it was not great enough to cause important changes in the composition of world trade. During the present war not only has there been a dramatic growth of the heavy metal and mechanical industries in most of the British Dominions and also in Brazil, but in other countries which have suffered aggression a firm determination to develop such industries as rapidly as possible after hostilities is becoming apparent.

Up to a certain point the diversification of the sources of national income is likely to prove a stabilizing factor as regards the economy of the newer countries. Their economy in the past has been exceptionally sensitive to fluctuations in foreign demand owing to the wide variations in the prices of primary products. On the other hand this development has probably tended to increase the instability of the older industrial countries. The younger industrial states concentrate in the first instance on the simpler manufactures—prepared foods, clothing, etc., while the older industrial states have, to an increasing extent, to change over from the export of these products to capital goods and durable consumers' goods, the demand for which is much less stable.

We may anticipate, however, that for a considerable number of years the urgent desire of the less advanced states to acquire capital goods for the development of their industries will provide a potential outlet for part of the output of the mechanical industries which have been so greatly expanded during the war in the highly industrialized belligerent states. At the same time, it would seem certain that the changes in world industrial structure will render trade uncertain and unstable unless a high degree of employment can be maintained in the great industrial countries. The exact nature of the effects of this war cannot be foreseen; but there is every reason to believe that the drift away from the relatively simple exchange of raw materials against manufactured products that characterized the trade of the early and middle nineteenth century will continue, and it is possible also that there will be a very rapid industrial development in countries with low labour

costs. But there is no reason for believing that in the long run trade will be reduced on this account; on the contrary it should increase with the rising standards of living of these peoples, and, as we shall endeavour to show, its ultimate stability is likely to depend mainly on the extent to which policies designed to maintain full employment are successfully applied in the great industrial states.

CHAPTER II

TYPES OF DEPRESSIONS

It has been suggested in the previous chapter that owing to the unprecedented economic progress of the last century the world has become more sensitive to the scourge of economic depressions. It is the purpose of this chapter to examine somewhat more closely what we mean by economic depressions, distinguishing different types and causes of depression.

The most significant general feature of depressions is the widespread unemployment of labour and material resources of production. As unemployed we must consider not only those resources, human and material, which are not being used at all, but also workers who are forced to accept jobs in which their skill is not fully utilized and labour and machines which are only employed part time. The effect of such unemployment or under-employment of resources is that national output and standards of living fall far below the level which could and should be attained with the available resources and technical knowledge, though it is inevitable that some skills and some types of machines will always be becoming redundant and incapable of adding to the national output. The "right to work" on which we laid stress in the first Part of our Report¹ is withheld under general unemployment from large numbers of people; there is a paradoxical coexistence of poverty with involuntary idleness, and unsaleable stocks of goods with low living standards or outright destitution.

The incidence and form of the loss of income and fall in standards of living differ somewhat between countries engaged mainly in industry and mining and those engaged mainly in agriculture. In the former, the depression takes the more direct form of unemployment of productive resources and a fall in physical output. If these countries specialize in the production of minerals, the fall in output is likely to be accompanied by a heavy fall in prices, leading to an even sharper decline in incomes and power to purchase imports. In agricultural countries the first and main impact of depression is generally a fall in the prices of their produce in-

¹ *The Transition from War to Peace Economy: Report of the Delegation on Economic Depressions, Part I, League of Nations, pp. 16-18.*

cluding what is produced for export (*cf.* Chapter V). The collapse of prices may be accompanied by no fall, or even by a rise in physical output. Unsold stocks of exportable goods accumulate or deteriorate; the incomes derived from exports fall and these countries suffer from a shortage of foreign exchange to pay for their imports.

It may occasionally happen that the disturbances in demand leading to industrial unemployment arise from uncontrollable fluctuations in harvest yields. But, owing to the inelastic demand for staple food products, this may as well occur when harvests are abnormally abundant as when they are short. Whatever its final cause, the immediate cause of the fall in world output and decreased living standards during depressions must usually be sought in industrial unemployment. Total agricultural production has shown itself relatively stable during the business cycle. If employment in industrial countries could be maintained at a stable high level, the major risk of depressions to countries producing raw materials and foodstuffs would be eliminated. We devote, therefore, the main body of this Report to a consideration of the means by which such stability might be secured in industrial countries. But we deal in Chapter V with the specific problems of primary producing countries and in Chapter XVIII with the measures which these countries may take to mitigate the effects of a failure on the part of industrial countries to maintain income and employment at a high level.

1. CYCLICAL, CHRONIC AND STRUCTURAL DEPRESSIONS

It is not necessary for our present purposes to enter deeply into an analysis of the causes of depressions, or to attempt to classify all the different types that present themselves. Reference to the work of Professors Haberler¹ and Tinbergen¹ will suffice to show the variety and multiplicity of possible cases. It is, however, important to distinguish, first, between cyclical, chronic and structural depressions, and, secondly, between general and partial depressions. These distinctions will be found to be of some significance for the discussion of policy in later chapters of this Report.

Cyclical depressions are a phase of the business cycle. They are characterized by widespread unemployment extending to all or

¹ G. Haberler, *op. cit.*; J. Tinbergen, *op. cit.*

almost all branches of industry and have an average duration of about two years, though showing wide variations.¹ Cyclical depressions are caused by certain deeply rooted relationships and time lags inherent in the mechanism of the individualist economic system and are closely bound up with the credit system, the durability of capital goods and the instability of investment. It is this mechanism which explains the similarity between different booms and depressions—the cumulative processes, the alternate spurts of investment and disinvestment, the parallel movements of money incomes and physical output.

The view is often expressed that the “mature” industrial countries are afflicted by a chronic type of depression, sometimes called secular stagnation. This condition, too, is characterized by widespread unemployment, though of a milder form than in most of the acute cyclical depressions. Chronic depressions are generally attributed to a permanent tendency to over-saving. In the rich industrial countries, savings are large and investment opportuni-

¹ The following table shows the number and duration of the business cycles in four large countries over a period of several decades:

Number and Duration of Business Cycles

<i>Country</i>	<i>Average Duration (months)</i>	<i>Range (months)</i>
United States: 20 cycles, 1854-1933:		
Expansion	25	9— 46
Contraction	22	8— 65
Full Cycle	47	29— 99
Great Britain: 15 cycles, 1854-1932:		
Expansion	36	8— 64
Contraction	27	6— 81
Full Cycle	62	26—135
France: 15 cycles, 1865-1932:		
Expansion	31	8— 62
Contraction	23	8— 61
Full Cycle	53	24— 95
Germany: 10 cycles, 1879-1932:		
Expansion	37	16— 61
Contraction	27	12— 61
Full Cycle	64	28—102

Source: Adapted from Table 139, “Average Duration of Business Cycles and their Variability”, in *Measuring Business Cycles*, by A. F. Burns and W. C. Mitchell, New York, 1945. The full cycles are measured from trough to trough; monthly data.

ties, it is assumed, become gradually restricted relatively to the large volume of saving. We reserve discussion of this type of depression for Chapter XVI below.

From these chronic depressions we should distinguish structural depressions. As we have seen in the previous chapter, the economic structure and environment do not remain constant; changes are constantly occurring in the art and instruments of production, in population growth, in consumers' tastes, in government policy at home and abroad, and above all, there are the major upheavals resulting from war preparations and wars themselves. These structural factors have a twofold effect on depressions. First, they account largely for the differences in the impact, length and severity of cyclical depressions, by affecting the operation of the cyclical mechanism. The worst depressions occur when structural maladjustments and institutional weaknesses coincide with a regular cyclical downswing of business. Thus, for instance, in the case of the Great Depression of the 'thirties, the cyclical set-back in 1929-31 was superimposed upon a basic maladjustment in world agriculture and was enhanced by the fragility of the international monetary system reconstructed after the last war, the weakness of the banking structure of certain important countries, and the failure of the main export industries in different parts of the world to adapt themselves to the shifts in demand and in economic power resulting from the Great War. Secondly, structural changes frequently produce long-lasting depressions in special areas or industries. This brings us to the two other types of depression which we distinguished above, namely, general and partial.

2. GENERAL AND PARTIAL DEPRESSIONS

This distinction too is of great importance from the point of view of anti-depression policy and to some extent it cuts across the distinction made above, since partial depressions are generally of structural origin.

In industrial countries a general depression is characterized by the existence of a deficiency of demand, unemployment, short time and excess capacity in almost all parts of the economy. This is typical of the situation that prevails during cyclical depressions.

A partial depression on the other hand is a situation in which unemployment exists only in certain industries or localities ("de-

pressed areas"). The cause of such depressions is two-fold. In the first place they are due to shifts in the demand (or changes in the conditions of supply) for particular goods or services, or for particular classes of goods. Thus they may arise from a decline in the foreign demand for exports, or from a change in fashion or tastes at home, or from the exhaustion or destruction of a natural resource; or they may arise from new inventions, as when the motor car diverted traffic from the railways, or the development of electric power reduced the demand for coal, or rayon and later nylon began to displace silk. In the second place they are due to the immobility of factors of production. If there were complete mobility, shifts in demand, or changes in the conditions of supply, might cause the decay of an industry and the loss of capital invested in it, but would not cause unemployment. Thus it is the rapidity of change in demand or in the conditions of supply on the one hand, and the degree of rigidity on the other, that are the main factors giving rise to partial depressions.

As a country recovers from a general depression it is likely to be confronted sooner or later by partial depressions. Many belligerents experienced this transition on the way from a depressed or semi-depressed position before they began re-arming to the height of the war boom. The first stages were easy: the bulk of unemployment was eliminated by general, even indiscriminate, spending. As employment increased bottlenecks began to appear in particular areas and occupations, and the road to expansion became more difficult.

In our discussion of policy we shall consider first the measures for dealing with general depressions and in Chapter XV partial depressions.

CHAPTER III

THE MECHANISM OF CYCLICAL FLUCTUATIONS

We have already referred to some of the characteristic features of cyclical economic fluctuations: the parallel movements of money incomes and physical output and the violent fluctuations in the accumulation of capital in various forms. We shall now attempt to describe the relationship of money income to total demand and in the next chapter shall turn to that part of total demand which is peculiarly unstable, namely, investment.

1. CHANGES IN MONEY FLOW AND DECISIONS TO SPEND

In reviewing the process by which changes in total demand take place we may concentrate attention either on the money flow itself or on the decisions of those who spend the money.

Incomes are created as a result of economic activity, and economic activity is dependent on expenditure. If the disbursements which are made during the process of production on wages, interest, raw materials, etc., make their way through incomes to the final purchase of goods, demand will be equal to income and the whole output will be sold. If, however, part of these disbursements are intercepted or disappear on the way, then total demand will not be sufficient to take off the whole product of the economic activity; some goods will remain unsold at current prices; prices may fall and production will subsequently be reduced. Conversely, if the disbursements resulting from economic activity are supplemented from some other source, total demand will be more than sufficient to take off the whole product; production will be increased and ultimately prices may tend to rise.

The possibility that the total demand for goods and services may be less than the money receipts resulting from economic activity arises from the fact that part of those receipts may not be spent either on consumption goods, or capital goods, or additions to stocks, but may be used to repay bank debts or simply hoarded. If this occurs and bank credit is not expanded in other directions equivalently, a net contraction of the flow of purchasing power results. This contraction may manifest itself either in a decrease in the total volume of deposits or in an increase in the average

period during which bank deposits are left idle, that is, not drawn upon by their owners.

The converse possibility that the total demand for goods and services may exceed the money receipts resulting from economic activity arises from the fact that demand may be swollen by the use of hoards or by an increased use of bank credit to finance production, the holding of stocks, or the purchase of consumers' durable goods. This expansion of purchasing power would manifest itself in an increase in the volume or velocity of circulation of bank deposits.

2. CUMULATIVE PROCESSES IN UPSWING AND DOWNSWING

Private investment is undertaken not for its own sake, but for profit, and the profit from additional investment ultimately depends on the sale of the additional output of consumers' goods which that investment makes possible. It is, therefore, not surprising that during both the upward and the downward phases of the cycle changes in consumption expenditure and investment expenditure react positively on one another. An increase in investment expenditure financed out of idle reserves or new credit will result in additional incomes of the workers, the suppliers of raw materials and others concerned. At least part of these new incomes will be spent on additional consumption of goods and services. As the demand for these goods rises, new investment in plant for their production will become profitable and there will be a further increase in investment, once more increasing incomes and adding to consumption expenditure.

As the process continues, intensifying forces come into play. Unemployed resources are progressively absorbed, and sooner or later costs and prices are likely to rise. The further utilization of productive capacity, combined with the fact that prices tend to rise faster than wages, means that profits increase also. The rise in prices sets up expectations of further rises, providing the basis for various speculative activities which accentuate the upswing.

A similar cumulative process occurs during the downswing. If investment expenditure falls off and workers are dismissed from the capital goods industries, their incomes fall and they in turn curtail expenditure on consumption. With a falling demand for consumption goods there is not only little inducement to new in-

vestment, but even the replacement of some of the existing equipment becomes unprofitable. Hence, output of capital goods falls still further, involving new dismissals and further curtailment of consumption expenditure. The fall in prices combined with rigidity of overhead and other costs involves businesses in losses and stocks are reduced more than proportionately to the fall in orders. If the credit institutions are weak or illiquid, the deflation may be accentuated by outright destruction of purchasing power through bank failures.

As we know from experience, however, these processes do not go on forever. They may come to an end in various ways. Even if the monetary authorities fail to secure stability, they may check an upward or downward movement. An expansion may come to an end through a deliberate deflationary policy, either by the Government (which is rare), or by the banks. Apart from credit restriction, profit expectations may also be depressed by sharp wage increases or speculative price increases. If nothing else intervenes, investment activity will ultimately slacken and fall off as, with the growth of savings, consumption demand ceases to increase at a rate sufficient to maintain the inducement to invest.¹ Moreover, even if consumption demand could be constantly stimulated so as to provide continuous new investment inducements, labour shortages would finally bring the expansion to an end. The sensitivity of the system to deflationary shocks tends to increase as the upswing progresses. This is evident in the monetary field as well as in the growing inelasticity of supply of factors of production. The shortages of labour and other productive resources are, however, the fundamental reason. It would theoretically be possible to maintain a perfectly elastic credit supply and to correct an adverse balance of payments by exchange adjustment or other means; but once the unemployed productive resources are absorbed any further credit expansion will lead to an inflation of prices, and not to an increase of output. In practice, inflationary symptoms due to localized labour shortages always appear long before full employment is reached.

The downward cumulative process, like the upswing, may also come to an end in various ways. For reasons we shall indicate, a depression is less likely than a boom to be stopped by banking

¹ Cf. Chapter IV, below.

measures alone. If there is no prospect of a positive return on investment, cheap or easily obtainable credit will offer no inducement to invest. Increased spending by public authorities may, however, bring a downward process to an end if the increased incomes thereby created lead to an expansion of consumption and induce in turn an increase in private investment. A stimulus to expansion may be provided through an increased demand from abroad or an important new invention at home. But apart from these possibilities, certain inherent tendencies towards recovery become operative after a prolonged depression. Durable goods, both producers' and consumers', eventually begin to wear out and the demand for their replacement may initiate a recovery in the industries concerned. Moreover, to some extent spending will be maintained if businesses make use of accumulated reserves or bank credit to cover their losses, and consumers attempt to prevent a further fall in their standard of living by contracting debts. The elasticity of credit and supply of unused factors of production at the bottom of a depression ensure that any increased spending will lead directly to an expansion of employment and not be dissipated in increased prices.

CHAPTER IV

THE STRATEGIC ROLE OF INVESTMENT

Although consumption of perishable goods is quantitatively much more important than capital accumulation, changes in the national income are much less likely to originate with consumption goods. Consumers' demand for such goods is generally limited by the income arising out of past activity; credit is not normally an important factor in determining the amount of the purchase effected. Moreover, unemployment insurance, widows' and old-age pensions, and similar measures of social provision, where they exist, exert in varying degree a stabilizing influence on consumers' demand for the necessities of life in periods of depression.

In the more highly developed and wealthy countries it is probably only in regard to durable and luxury goods that consumption expenditure is likely to have an actively destabilizing influence. Spending on these goods may rise rapidly during a boom when incomes are high, and spending power is inflated by capital gains and the expansion of instalment credit. It tends to be curtailed sharply during a depression, when incomes drop, debts are repaid, and instalment payments have to be maintained. Thus, while consumers' expenditure on non-durable goods may be regarded as a relatively passive factor in the business cycle, expenditure on consumers' durable goods plays a more active role analogous to that of investment. In less highly developed or less wealthy countries, however, where expenditure on luxury goods and also instalment credit are not so important, the influence of expenditure on consumers' durable goods is not likely to be so great.

1. INFLUENCE OF INCOME CHANGES ON INVESTMENT

Consumers' expenditures on durable goods and investment are affected by changes in income, just as are consumers' expenditures on non-durable goods; but in contrast to the latter, their relationship to income changes is both unstable and destabilizing. The reasons for this instability arise from the fact that¹ "changes in

¹ A more elaborate account of this principle (the "acceleration principle of derived demand") with reference to the original literature will be found in *Prosperity and Depression: A Theoretical Analysis of Cyclical Movements*, by Gottfried Haberler (L. of N., 1939. II. A. 4(1), pp. 85-105: Third edition, Geneva, 1941).

the demand for and production of finished goods and services tend to give rise to much greater changes in the demand for and production of those producers' goods which are used in their production."¹

This principle applies alike to durable producers' goods, producers' stocks and to durable consumers' goods, though with unequal force.

(a) Its application to the first category of goods may be illustrated by a simple numerical example. If for instance an annual increase of 1 per cent in the demand for shirts could be met by building 100 new machines each year, then a rise in the rate of increase in the demand for shirts to 2 per cent per annum would necessitate the building each year of 200 new machines. Therefore, assuming that there were no replacement demand for machines, a jump from a rate of increase of 1 per cent to a rate of increase of 2 per cent in the demand for the final consumers' goods—shirts—would in this case tend to a doubling of the demand for the producers' machines. An important result of this technological relation between the demand for currently consumable goods and services and the demand for the durable instruments used in producing them is that the output of durable goods can decline as a result of a mere slackening in the rate of increase in consumers' demand, and does not depend on there being any absolute fall in consumers' demand. If, for example, in the above illustration, the addition of 200 machines to the capital stock were necessary to enable consumption to increase at the rate of 2 per cent per annum, a relapse of the rate of increase to 1 per cent per annum would result in a decline in the necessary additions to the stock of capital from 200 to 100.

(b) The same principle applies less rigorously to investment in working stocks, as in this case it depends not on any technological necessity but on the habit of producers and distributors of varying their stock holdings in proportion to the rate of output or sales. To take another simple example: assume the monthly sale of men's shirts is initially 100,000 and that dealers normally hold stocks equal to one month's demand. If sales rise to 110,000 dealers will increase their orders immediately after this change to 120,000 in order to adjust their holdings in proportion to the higher rate of sales. Similarly if sales fall off, the dealers can re-

¹ *op. cit.*, p. 88.

duce their orders by more than the reduction in sales while they get rid of such stock as is in excess of the month's supply at the new rate of turnover.

(c) The case of durable consumption goods is analogous to that of durable producers' goods, if we replace the "annual production" of shirts in the above example by the "annual service" rendered by, for instance, a house, motorcar, or washing machine. That service is rendered by the whole existing stock of these durable goods. Quite a small change in total demand for the services of durable goods may represent a very large change in the requirements of new durable goods.

In all these cases a decline in new investment or demand for new durable consumers' goods is associated with a falling off in the rate of increase in the demand for current goods and services. Such a falling off is, in fact, likely to occur in the course of the cycle as consumers tend to increase the proportion of income saved as their incomes rise, and this will eventually bring about a decline in investment.

2. REPLACEMENT DEMAND FOR CAPITAL GOODS

In considering the effect of a change in the rate of increase of consumers' demand on the output of capital goods, account must be taken of the fact that some capital goods are produced to replace existing goods and not to add to the stock. Suppose that the stock of capital equipment at a given base date is 100, annual consumption of the final goods produced by this capital equipment 20 and annual production of new capital goods 8, of which 4 is to replace worn-out and obsolete equipment and 4 to add to the stock. Suppose now that consumption of the final goods increases suddenly from 20 to 22, *i.e.* by 10 per cent. The stock of capital must increase in proportion, *i.e.* from 100 to 110. The output of new capital must therefore increase from 8 to 14 (including the 4 required to replace old equipment) or by 75 per cent. If consumption should level off and remain constant, then the existing capacity is sufficient and no additions to the stock of capital are required. If consumption falls, not only does the demand for additions to capital fall to zero, but it is not even necessary to maintain the stock of existing machines, so that replacement demand falls as well.

It might be thought that replacement demand for capital goods would act as a stabilizing factor in the output of durable goods. But this demand too is postponable and affected by general fluctuations in the state of business. In periods of prosperity and optimism, machinery tends to be written off quickly and replaced, while in periods of depression and pessimism, replacement is often postponed. The sudden increase in the demand for machine tools in the United States of America in 1935 and the modernization of out-of-date equipment in the steel industry in 1936 were examples of replacement demand stimulating an upswing.¹

3. FLUCTUATIONS IN INVESTMENT

The wide difference between the amplitude of the fluctuations to which the output of durable goods and changes in stocks are subject, and that of the fluctuations in the production of perishable consumers' goods and services, is illustrated in Table III, below, which shows the principal components of the national output of the United States during the period of 1921-1938.

Although non-durable consumers' goods and services accounted, on the average, for about three-quarters of the value of gross national output, the average changes in the value of that output were slightly less than the changes in all other types of expenditure taken together. Their percentage deviation was about 11 as compared with about 25 for producers' durable goods, 24 for consumers' durable goods and 57 for residential building.

The data in Table IV for the United Kingdom are less conclusive than those available for the United States of America; none the less they illustrate the much wider fluctuations in the output of durable goods of various sorts than in goods destined mainly for immediate consumption. The three classes of durable goods shown accounted for only about 15 per cent of aggregate production covered by the table, but the value of their deviations from the average accounted for nearly 27 per cent of the total.

As a final illustration for this important point, Table V gives similar data for Sweden. The upward trend of output was very marked in this country over the period covered (1919-1934), so

¹ Cf. Alvin Harvey Hansen, *Monetary Policy in the Upswing*, in "The Lessons of Monetary Experience", Essays in honour of Irving Fisher (London, 1937).

TABLE III
*Components of National Output¹ of the United States
 of America, 1921-38*
 \$(000,000)

	Value in 1929		Value in 1932		Average Value 1921-38		Mean Annual Deviation from average 1921-38	
	\$ mil- lions	% of total	\$ mil- lions	% of total	\$ mil- lions	% of total	\$ mil- lions	% of average
Consumers' Non-durable Goods and Services	68,096	69.4	44,573	86.7	56,298	74.0	6,008	10.7
Consumers' Durable Goods	9,913	10.1	3,806	7.4	7,004	9.2	1,648	23.5
Residential Construc- tion	3,010	3.1	444	0.9	2,623	3.4	1,491	56.9
Business Con- struction	4,581	4.7	1,098	2.1	2,818	3.7	1,105	39.2
Public Con- struction	2,928	3.0	1,869	3.6	2,455	3.2	484	19.7
Producers' Durable Goods	6,908	7.0	2,019	3.9	4,713	6.2	1,168	24.8
Net Change in Inven- tories	2,414	2.4	-2,461	-4.7	329	0.4	1,377	418.5
Net Foreign Invest- ments	312	0.3	40	0.1	-102	-0.1	657	644.1
Total	98,162	100	51,388	100	76,138	100	12,153	16.0

¹ The figures for commodity output in this table are derived from Dr. Simon Kuznets' *Commodity Flow and Capital Formation*, supplemented by Bulletin 74 of National Bureau of Economic Research (New York, 1938 and 1939, resp.). The estimate of consumers' expenditure on services, from Table 22, Appendix A, of Dr. Harold Barger's *Outlay and Income in the United States, 1921-1938* (National Bureau of Economic Research, New York, 1942, pp. 226 *et seq.*), has been added to Dr. Kuznets' estimates of the flow of consumers' perishable and semi-durable goods to give the first item in the table.

TABLE IV

Some Components of National Output of United Kingdom, 1924-37¹

Groups of commodities	Average value 1924-37 at 1930 prices	Average annual deviation from average 1924-37	
	£(000,000's)	% of average	
Production of Producers' goods (incl. building)	613	87.2	14.3
Residential building	114	58.9	51.6
Production of private cars and taxis	47	15.2	32.2
Production of Consumers' moveable goods (less passenger cars)	4,379	441.5	10.1

¹ Based principally on estimates made by Colin Clark.

TABLE V

Some Components of National Output of Sweden, 1919-34¹

Groups of commodities	Average value 1919-34 at 1930 prices	Average annual deviation from trend 1919-34	
	kronor (000,000)	per cent	
Production of moveable Producers' goods	769	81.3	10.5
Residential Building	176	26.7	15.2
Non-Residential Building	627	86.6	13.8
Production of moveable Consumers' goods	6,223	229.5	3.7

¹ Based on Erik Lindahl *et al.*, *The National Income of Sweden, 1861-1930* (being Vol. III. of *Wages, Cost of Living and National Income in Sweden, 1860-1930*, by the Staff of the Institute for Social Sciences, University of Stockholm: Stockholm, 1937; P. S. King and Son, Ltd., London, 1937).

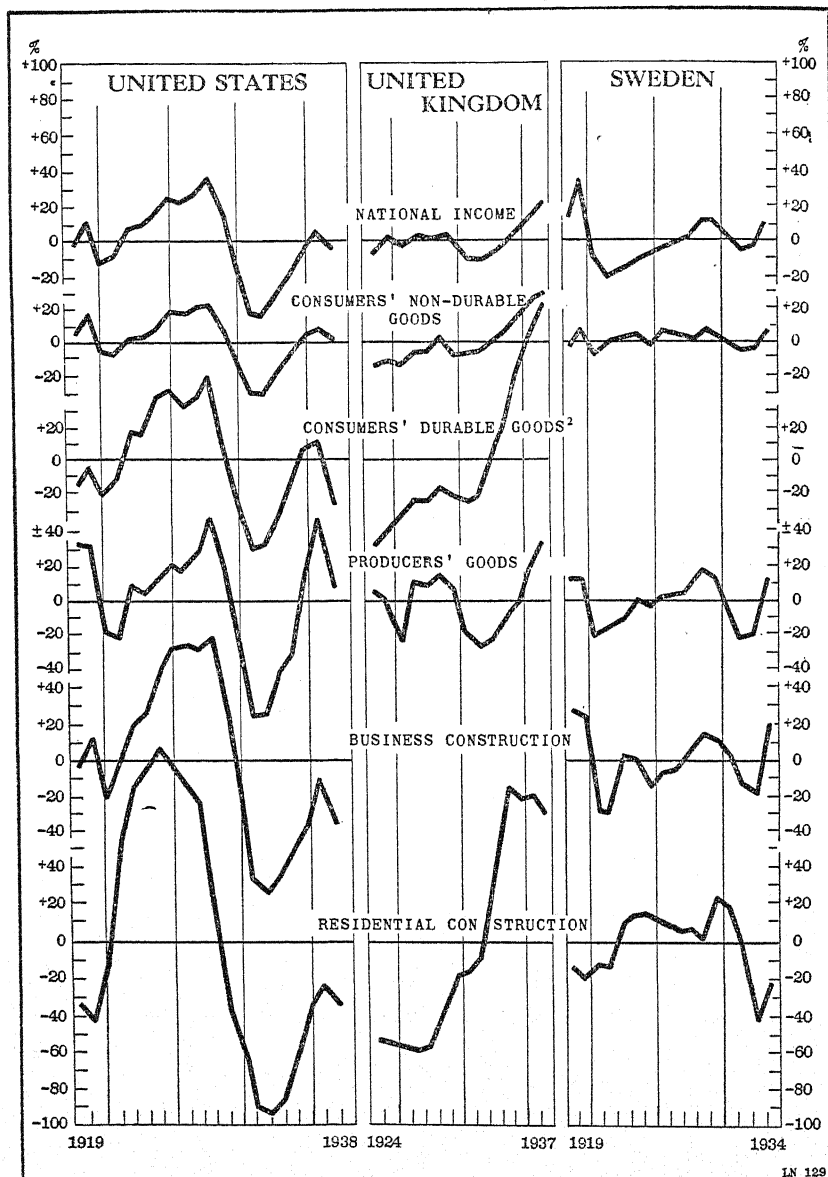
in this case the annual deviations have been measured not from the average but from the calculated trend figure.

The evenness of the output of moveable consumers' goods is particularly striking, the average annual deviation from the trend amounting to less than 4 per cent in the 16 year period covered. Though this category of goods constituted 80 per cent of the aggregate covered by the table, the value of its deviations from the trend was only slightly greater than the total value of the deviations directly caused by the industries accounting for the other 20 per cent.

The fact that the timing of the fluctuations in the output of the principal categories of durable goods is directly related to the timing of the fluctuations in economic activity in general is illustrated in Diagram I.

DIAGRAM I

Annual Percentage Deviations in Output of Various Classes of Goods and in National Income in the United States of America, the United Kingdom and Sweden¹



¹ The deviations are measured from the average, in United States and United Kingdom, and from the trend, in Sweden.

² United Kingdom: Private motor cars and taxis only.

4. SHORT- AND LONG-TERM INFLUENCE OF INVESTMENT ON EMPLOYMENT

The relationship between variations in investment expenditure and in the national income is reciprocal: fluctuations in investment expenditure give rise to fluctuations in the national income; while the latter, by changing profit expectations, in turn cause fluctuations in investment. But the relationship is not symmetrical. For whereas, if the rate of investment could be stabilized, we should expect national income to remain more or less stable or to increase in a stable way, the opposite would not necessarily be true: a stable level or steady growth of national income would not necessarily ensure freedom from all fluctuations in private investment. Some part of the instability of private investment would certainly be avoided; but the tendency for investment to proceed in jerks as a result of new inventions and the factor of durability in conjunction with the acceleration principle would still remain.

Apart from constituting the main source of instability in the economic process, investment plays a crucial role also in determining the average level of employment. We have seen that the volume of consumption (and consequently savings) is more or less rigidly determined by national income. With a given relationship of consumption to income, the level of employment will depend on the amount of investment being undertaken; if more is being invested than people wish to save out of existing incomes, incomes will rise, and so long as unemployed resources are available, output and employment will increase also. Similarly if less is being invested than people wish to save from current incomes, the level of income and employment will fall.

We must distinguish here between two kinds of net investment. The first kind is investment which is immediately dependent on an increased demand for consumption goods. This kind of investment consists of additions to plant or working stocks needed to expand the output of existing types of consumers' goods and services, and it takes place only if there is an assured market for the additional consumers' goods and services to which it gives rise. Always assuming that there is no change in methods of production, consumption demand must, as we have seen, expand persistently by equal amounts each year, in order to sustain a constant volume of such net investment. The difference between gross and net investment is

the amount required to maintain existing equipment. It is of course not dependent on any increase in the demand for consumers' goods, but will remain more or less constant so long as the demand is constant. The second kind of net investment occurs, at least in the short run, independently of a change in consumers' demand. It takes place in the response to various dynamic factors such as new inventions, the opening up of new territories, the discovery of new resources, and so on.

(a) *Building.*

Of the various types of investment activity referred to above, the most important is building. Not only are buildings the most durable of all capital goods, but they account for a very large proportion of the total capital expenditure in all countries. In the United States, for example, average annual expenditure on private building—residential and business—averaged \$5,441 millions during the period 1921-38, as compared with total gross capital formation averaging \$12,836 millions per annum.¹ In the United Kingdom the gross value of building and contracting in 1930 was estimated at £340 millions out of a gross output of all capital goods of £607 millions.²

Expenditure on building varies widely from year to year. In the United States the value of new private building ranged from about \$9,300 millions in 1925 to as low as \$1,300 millions in 1933. A reduction in these wide fluctuations in building activity would make an important contribution to economic stability.

If we try to analyze the effective demand for houses, which constitutes so important a segment of building activity, in terms of its main determinants, we may distinguish three main components: the real housing needs, income and cost factors and the existing stock of houses. The housing needs of the community are determined in the first instance by the number of new households and the movement of population from one area to another. The degree to which these needs are satisfied is generally dependent on the level of family incomes on the one hand and the cost of providing

¹ Derived from Simon Kuznets, *Commodity Flow and Capital Formation* (see Table III, above: Total, less first two items).

² Colin Clark, *National Income and Outlay* (London, 1937), p. 177.

new houses on the other. The change in output resulting from an increase in income is, however, by no means limited to the amount by which income is increased. The ability to pay £10, for instance, per month in rent (and confidence in the future ability to do so) may well lead to the construction of a house costing £1,200, provided credit is available for the purpose. This ability depends, of course, not only on the level of money incomes, which fluctuate with the trade cycle, but also on the prices of other objects of expenditure. Thus it is generally assumed that the sharp fall in food prices in the United Kingdom after 1929 was—along with the fall in interest rates—one of the most important factors responsible for the high level of building activity in subsequent years. As the demand for new or better housing accommodation is optional, it is “liable to epidemics of postponement and advancement”.

On the cost side, an important role is played by the conditions and terms of financing. This may be illustrated by a simple numerical example. Suppose a householder has been paying 6 per cent interest on a mortgage of £1,000 or £60 per annum. If the current rate on mortgages falls to 4 per cent, he is able with the same outlay to support a mortgage of £1,500; and if he is able to raise the funds he will probably improve his housing accommodation. A lengthening of the period of amortization, from say 20 to 30 years, is equivalent to a reduction in the rate of interest in its effects on annual carrying charges. It has been estimated, for instance, that a change in financing charges from $6\frac{1}{2}$ per cent amortized over 20 years to $4\frac{1}{2}$ per cent amortized over 30 years would (on the basis of income levels of 1929) have enabled 5 million more families of moderate incomes in the United States of America to support the ownership of a minimum-priced house adequate to their needs.¹

In addition to changes in the long-term cost of financing, changes in the ease with which funds can be raised for construction projects exercises an important influence on fluctuations in residential construction. In some countries the rate of mortgage loans moves within a very narrow range. Financial conditions exert their

¹ L. J. Chawner, *Economic Factors Related to Residential Building*, in *Annals of The American Academy of Political and Social Science*, March, 1937.

influence mainly through changes in the percentage of the total costs of construction which the lender is willing to advance, or in his valuation of the contemplated structure. In good times, lenders are optimistic and competition between them takes the form of the offer of higher amounts rather than willingness to accept lower rates. In this way speculative builders are enabled to construct dwellings and apartment houses in advance of demand with very little equity money. Construction is stimulated by the high return on the equity so long as demand is brisk; but when demand falls the equity is soon wiped out, foreclosures become frequent, the mortgage market is demoralized and it becomes difficult to obtain money for new projects on any terms.

The volume of construction is affected not only by financing costs, but also by taxes and costs of building. If costs of building materials and labour are high in relation to other incomes and costs, the level of new construction will be low, and conversely if these costs are low. Where costs are very rigid, slight changes from the demand side will cause proportionately greater fluctuations in the return on capital, and hence on the volume of construction.

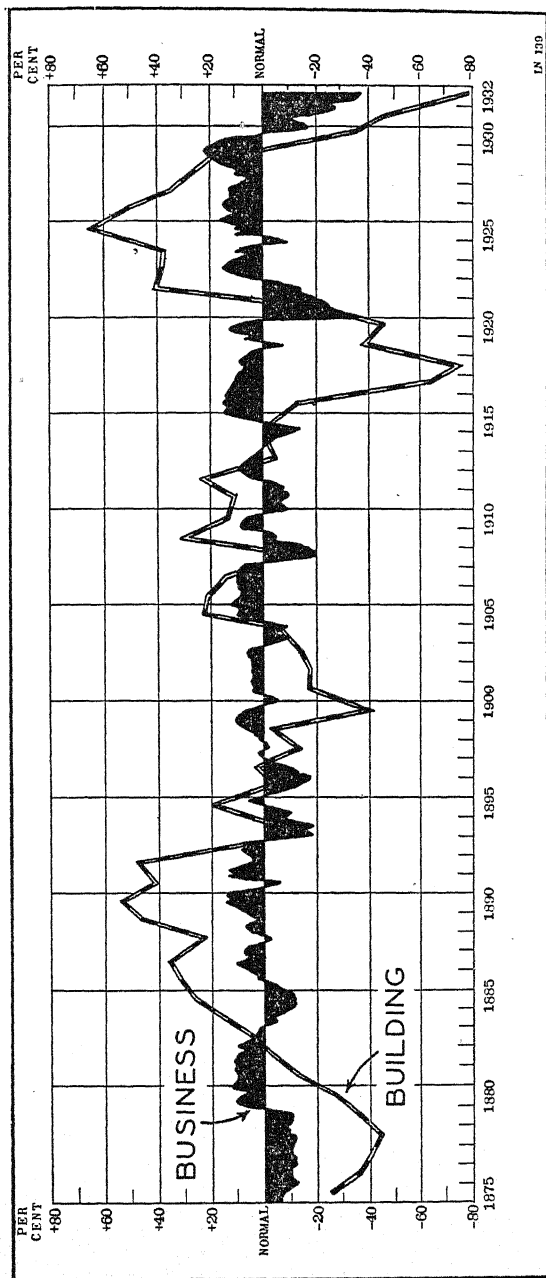
In so far as the level of new building is dependent on fluctuations in the relationship of incomes to costs, one might expect changes in building activity to be roughly simultaneous with, though because of their wide amplitude not parallel to, changes in general business; and indeed this appears to be commonly the case. In the United States, however, evidence has been found of the existence of a longer cycle of building activity, with a duration of 15-20 years. This is illustrated by Diagram II.

Long period fluctuations would seem to be due to the exceptional durability of houses, as a result of which the after-effects of a building boom are of longer duration than those of a boom in the production of less durable products. Hence in addition to basic housing needs, and to current incomes and costs, the stock of houses in existence plays an important role in determining the level of current building activity.

It will be seen from this Diagram which relates to the United States that the major building fluctuations contain smaller cycles, corresponding with the movements of general business activity. The smaller movements are most acute when their direction coin-

DIAGRAM II

Building Cycles Compared with General Business Cycles in U.S.A., 1875-1932¹



Building Curve prepared by Division of Building and Housing, U.S. Dept. of Commerce.

General Business Index adapted from Cleveland Trust Co. Curve—Trend and Curve Revised, 1920-38.

¹ From John R. Riggleman, *Building Cycles in the United States, 1875-1932*, Journal of American Statistical Association, June, 1933, p. 181.

cides with the downward movement of the cycle in other economic activity; the effects of contraction of building on the general level of employment may be extremely serious.

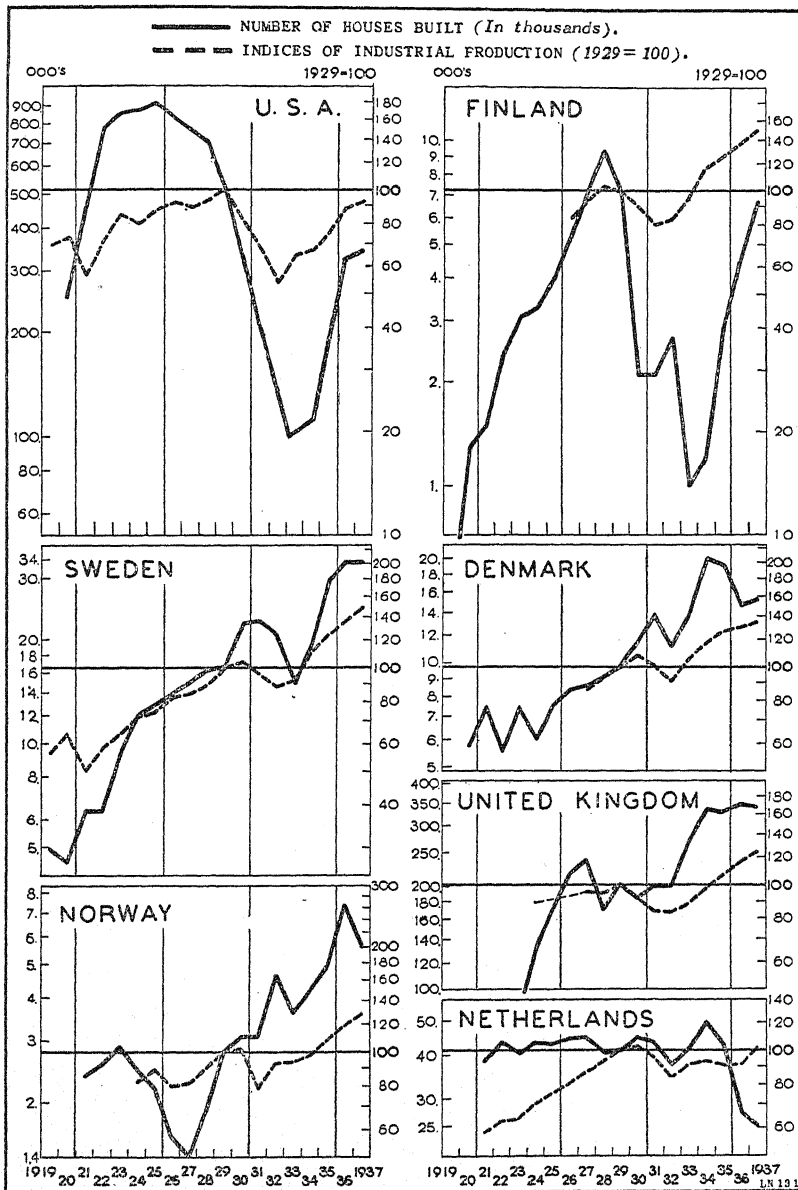
The exceptional instability in the output of houses is illustrated in Diagram III which shows for a number of countries the annual fluctuations in the output of new houses since the last war, compared with movements in industrial production. It will be seen that in no case is the range between the lowest and highest years less than about 100 per cent, and in most countries the maximum annual output of houses was several times the minimum annual output.

The wide amplitude no less than the unusual length of building cycles is mainly due to the durability of buildings. The difficulty of adjusting supply to demand through purely private initiative are particularly great in this industry. Detailed information regarding supply and demand is very scarce; statistics of vacancies are frequently not available; each building has an individual location and there is no organized market which would, through price quotations, reflect the trend of supply and demand. The industry is largely in the hands of numerous small firms which reinvest their profits in their own business, a fact which, in the absence of accurate information about the market, accentuates the tendency to periodic over-building. This tendency is aggravated both by the rigidity of rents during the currency of old leases despite slackening demand and by the necessary delay between decisions to undertake new construction and the actual provision of new houses.

Particular difficulties are caused by the abnormal interruption of building activity during wars. Without careful planning the repercussions in the inevitable post-war boom may result in accentuated fluctuations in building activity for many years to come. This problem will be particularly acute and call for the most careful planning after the present war owing to the enormous destruction of houses in countries subject to bombardment.

DIAGRAM III

*Output of Houses and Industrial Production
in Various Countries, 1919-37*

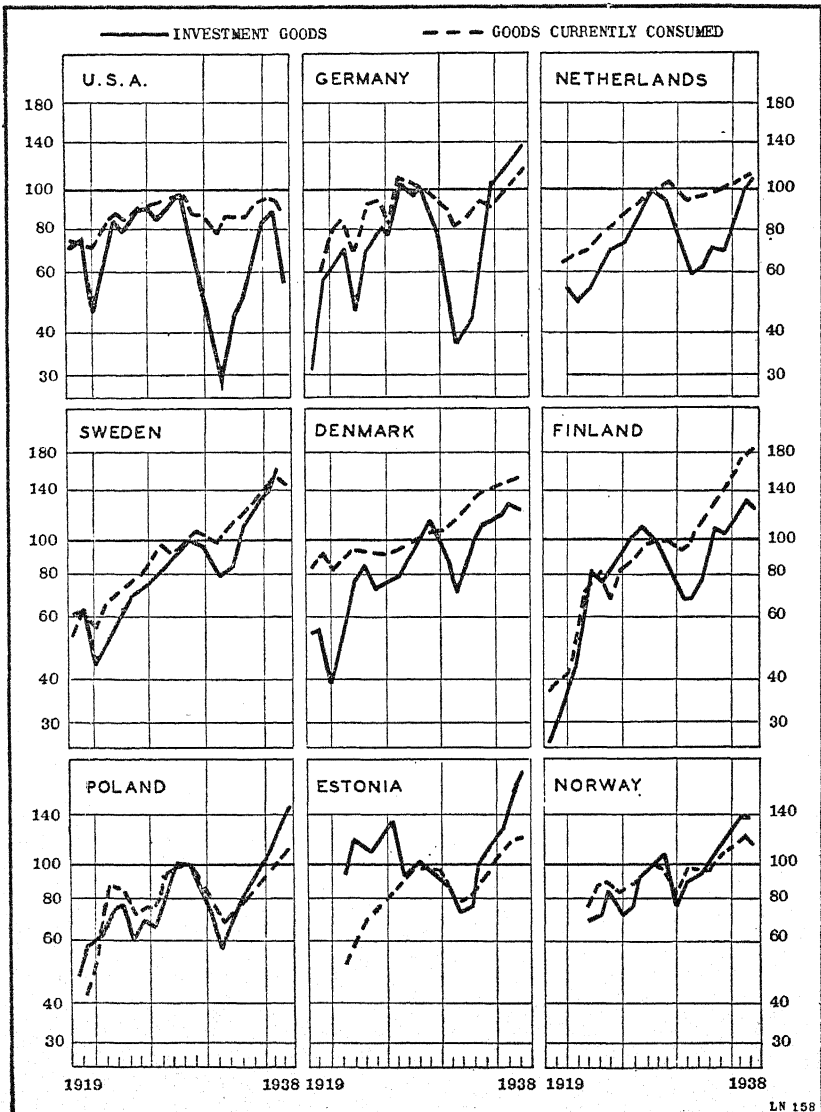


(b) *Producers' Plant and Equipment.*

Diagram IV illustrates the much greater cyclical variability of the industries producing investment goods than of those producing

DIAGRAM IV.

*Indices of Production of Investment Goods and of Goods
Currently Consumed in Various Countries, 1919-38*
1929 = 100



consumers' goods. We have already discussed the main general causes of this phenomenon at the beginning of this chapter.

The output of producers' plant and equipment serves two purposes. One part of it goes to replace existing capital goods as they are worn out or discarded, while the other part constitutes a net addition to the stock of such goods in existence. It is difficult to distinguish between the two statistically and both depend on the anticipated demand for capital goods. Existing capital is not, in fact, always maintained, and the degree to which it is allowed to run down or is built up again depends on profit expectations in precisely the same way as the construction of new capital.

The anticipated profitability of an investment—whether to make good wear and tear or to constitute a net addition to capital—depends on the difference between expected costs and expected returns. The main factors in determining profit expectations differ according to the type of investment. In some cases, as we have already indicated, they depend largely upon the discovery of new methods of production, the introduction of new goods, or the opening up of new territories.

But the level of incomes and effective demand are also important in determining the actual level of this type of investment. It will not be profitable to introduce new goods or methods unless there is likely to be a demand for them. Hence, even if the inventions themselves occur more or less regularly, the investments based on them are likely to be effected during periods of increasing prosperity and to stop when demand slackens.

This is even more true of the kind of investment, which is dependent exclusively on changes in consumers' incomes. It applies, in some degree, both to replacement demand and to the demand for new capital goods, though the former is affected mainly during the downswing and the latter during the boom. When business is bad replacements are postponed, but as soon as demand begins to improve, the backlog of replacements will be made up, leading to an intensified demand for capital goods for this purpose. The demand for new investment goods, on the other hand, will not respond at once to an increase in consumers' demand at the bottom of the depression, owing to the existence of idle capacity.

In addition to the investment resulting from the chance of inventions or the expansion of consumers' demand, a demand for

machinery and other capital goods may arise owing to the spread of labour-saving devices. This may result from new labour-saving inventions, but may also be caused by changes in the relative costs of labour and capital, which may in turn be subject to cyclical influences.

In addition to the demand for capital goods for domestic investment, a further cyclical influence is likely to arise from the export demand. For reasons which are discussed in Chapter VI, there is a tendency for fluctuations in business to occur almost simultaneously in different countries, with the result that foreign demand for capital goods ebbs and flows simultaneously with domestic demand.

(c) *Changes in Stocks of Goods.*

In addition to durable equipment, investment may also take the form of changes in stocks of goods. Unfortunately in examining the behaviour of this element in gross capital formation, we are hampered by lack of statistical data. Governments have, however, obtained during the war much additional information regarding stocks, and it may be hoped that up-to-date statistics regarding stocks of raw materials and semi-processed goods in the hands of producers, industrial consumers and dealers as well as regarding stocks of finished goods in the hands of producers, wholesalers, retailers, and consumers, will continue to be collected and will be made available to the public after the war.

The importance of stocks in the economic system may be illustrated by the following diagram (Diagram V) which shows the estimated value, at current prices, of stocks of goods held by business firms in the United States at the end of each of the years 1918-1941, together with, for purposes of comparison, the national income.

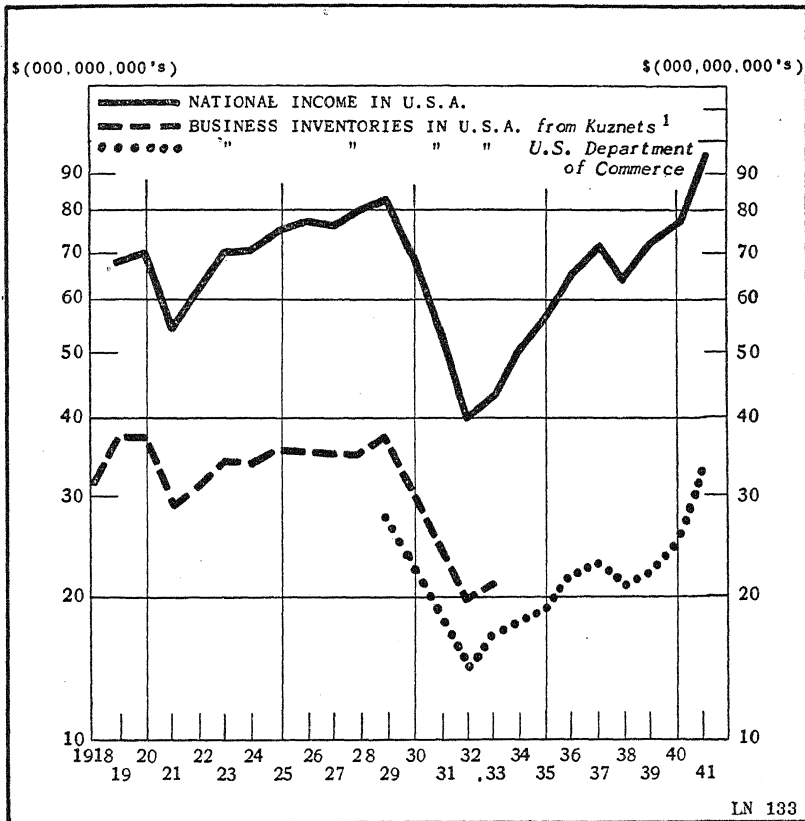
It appears that stocks fluctuated in these years from somewhat under \$20 to \$37 thousand millions, and that they ranged from 40 to 45 per cent of the national income. They appear to have been of roughly similar proportion in the United Kingdom. For instance, the national income of the United Kingdom has been estimated at approximately £3,900 million in 1931 and stocks at the end of that year at £1,650 million.¹

¹ Colin Clark, *National Income and Outlay*, pages 88 and 297.

DIAGRAM V

*Inventories (Stocks of Goods) and National Income in U.S.A.,
1918-41*

\$(000,000,000's) at current prices



¹ S. Kuznets, *Commodity Flow and Capital Formation*, National Bureau of Economic Research, New York, 1938.

The mere fact that large stocks of goods of various descriptions must be held at various points in the economic system to ensure an uninterrupted flow of goods from producer to final consumer tends to aggravate cyclical movements. For a rise in prices during a period of expansion leads to a higher valuation of stocks of goods; these book profits, even though they cannot be realized, may be regarded as income and lead to additional dividend distributions or expenditure on plant. The higher valuation of stocks

tends to make business men optimistic and thus to stimulate further investment. Conversely, when prices decline, book losses on stocks, even if unrealized, may be regarded as a deduction from income, reducing the funds available for spending; in addition to this effect these losses give rise to pessimism and may have a deterrent effect on investment.

But more important than the changes in value of commodity stocks are the changes in the quantities. In Diagram VI these changes are compared with the sum of the other elements of gross capital formation and with total gross capital formation in the United States. The three series are expressed at 1929 prices throughout and, in order to render their relative amplitudes more easily comparable, are shown as deviations from their annual average over the period 1919 to 1938.

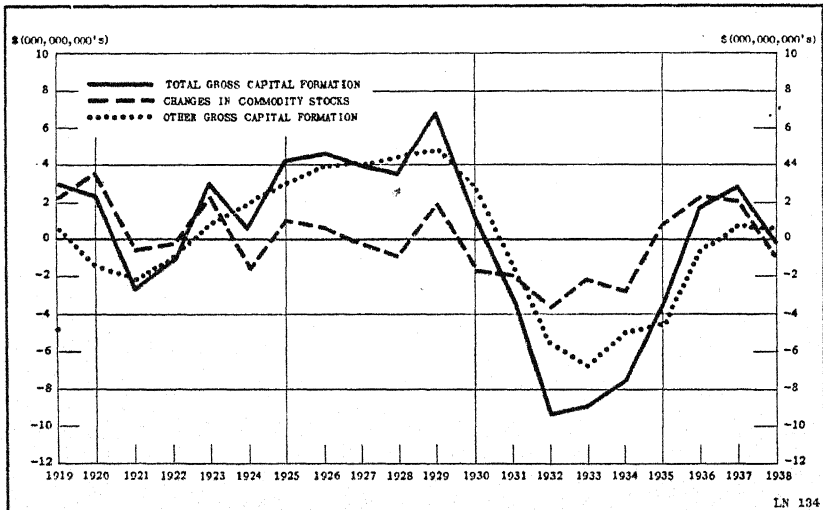
This diagram suggests that changes in stocks played an important role in the minor fluctuations in total capital formation which

DIAGRAM VI

*Changes in Commodity Stocks and in Total Gross Capital Formation
in U.S.A., 1919-38*

(Deviation from 1919-38 average)

\$(000,000,000's) at 1929 prices



Source: S. Kuznets: *Commodity Flow and Capital Formation*, National Bureau of Economic Research, New York, 1938.

did not lead to any major depression, but that during major depressions stocks were more stable than other elements in total capital formation. This fact may be largely explained by the complex motives leading to changes in the quantities of commodities held in stock. In Chapter V we consider in more detail the considerations underlying the accumulation of stocks of primary products; but three main tendencies in the stock-keeping policies of industrial entrepreneurs may be briefly mentioned here:

(i) The quantity of goods in a semi-finished state held by each firm is partly determined by its rate of turnover. When production is active more goods are moving through factories and are tied up in the process of production than during periods of restricted activity. The tendency for stocks to vary with the volume of production is not confined to semi-finished products. A factory requires a larger stock of raw materials to keep production going at boom than at depression levels, and a wholesaler or retailer will want a larger stock of the commodities he sells when sales are large than when they are small.

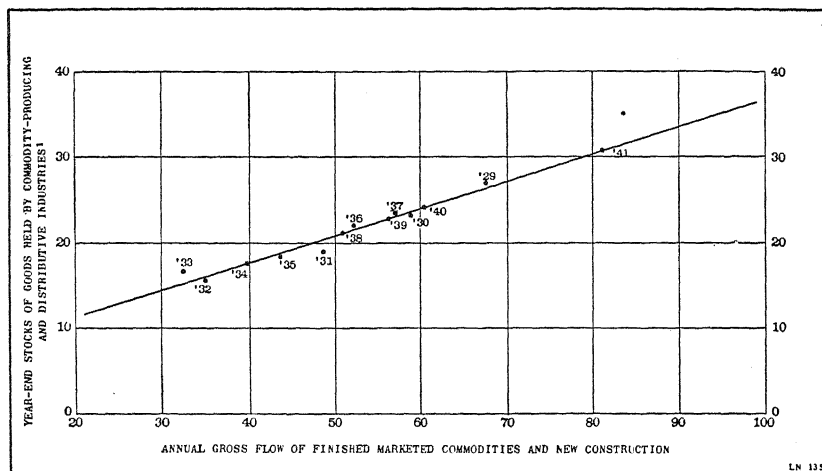
Diagram VII shows a striking relationship between stocks and the flow of finished commodities in the United States for the years 1929 to 1941. But stocks did not change proportionately to the flow of commodities; an increase or decrease of 1 per cent in output was accompanied by a change in stocks in the same direction of about one third of one per cent. Accordingly, the percentage which stocks constituted of turnover was larger in the depression years (about 50 per cent in 1933) than in boom years (40 per cent in 1929, 37 per cent in 1941). But though stocks were thus more stable than turnover, the fact that they change in the same direction as turnover tends to aggravate cyclical fluctuations. When consumers' demand becomes constant, this additional demand for stocks disappears; and when consumers' demand begins to fall, production will fall even more as stocks are drawn upon to meet part of the remaining demand.¹

(ii) Entrepreneurs, however, are influenced not only by the present rate of turnover but by market expectations. When a rise in prices or costs is expected to take place, the accumulation of

¹ This effect of changes in stocks of goods on cyclical fluctuations was referred to in connection with the "acceleration principle" outlined above (section 1 of the present chapter).

DIAGRAM VII

*Relationship Between Year-end Inventories (Stocks of Goods) and
Gross Flow of Finished Goods and New Construction
in U.S.A., 1929-41*
\$(000,000,000's).



Source of data: United States Department of Commerce: *Survey of Current Business*, September 1942, p. 15.

¹ Data do not include agricultural industries.

stocks is profitable, and producers and, especially, traders will try to increase their stocks for motives ranging from cautious covering for a known future demand to pure speculation. If the expected rise in prices is large, consumers too will endeavour to buy as much as possible in anticipation of future needs for fear of having to pay higher prices a few months ahead. It appears in most cases that the price expectations giving rise to such "speculative" accumulation of stocks of goods are the result of an actual observed rise in prices; and the accumulation of stocks itself, representing an additional demand in the market, will tend to make the anticipations come true. Conversely, when a fall in prices is anticipated, entrepreneurs will try to keep their stocks down to a minimum in order to minimize losses on inventories.

Speculative stocking and de-stocking waves of the type outlined played an important role in at least two of the short cycles in the inter-war period. In 1919, after the termination of wartime price controls, actual and anticipated price increases contributed to the

first post-war boom in which commodity speculation was an important element.¹ Again in 1936 and 1937 the rapid rise in raw material prices and wage rates in the United States led to sharp increases in the volume of stocks held by wholesalers and also by retailers in anticipation of higher prices. It is characteristic of booms such as these that they do not last. The accumulation of stocks undermines the basis for further speculation, the anticipation of a persistent rise in prices. If the rise in prices originates—as seems to have been the case in 1936/37—from the fact that industrial production advances faster than the supply of raw materials that could readily be made available, the production of these materials will after a short time expand and prices will break. Another limit to the advance of prices may be set by the fact that the banking system, however elastic, cannot put unrestricted credit at the disposal of the market for speculative or quasi-speculative purposes. Whatever the specific reason, a speculative boom is likely to generate the conditions for its collapse after a relatively short period of time and to lead to a depression, unless other forms of investment increase sufficiently to maintain total investment at a high level.

(iii) A third type of policy respecting stocks of goods is sometimes followed by the producers of fabricated and semi-processed goods: plant is kept operating for stock when sales fall and stocks are reduced when demand is high. An American study² has shown that of twenty-three finished products for which stock figures were available from 1919 to 1932, in twelve cases the fluctuations in stocks were in inverse relation to the cycles in general business and in eleven cases conformed positively. The industries which sought to reduce cyclical fluctuations in production in this way had, characteristically, large productive capacity and heavy overhead costs which go on regardless of the rate of operation. The products were durable and not subject to physical deterioration; as a rule they were not final consumption goods and were subject to fairly stable long-term demand.³ Typical commodities in this group are newsprint paper, cement and enamelled baths. On the other hand the

¹ League of Nations: *Economic Fluctuations in the United States and the United Kingdom, 1918-1922* (L. of N., 1942. II. A.7).

² R. H. Blodgett, *Cyclical Fluctuations in Commodity Stocks* (Philadelphia, 1935).

³ *op. cit.*, pp. 98-99.

stocks which show a positive conformity with business activity included more final consumption goods and goods subject to physical deterioration or to changes in style. Typical of this group are refined sugar, wheat flour and knit underwear.

It is clear that this third type of policy acts as a stabilizing factor in business cycles and, at the same time, has definite advantages for the producers of certain types of commodities. It is probable that similar fluctuations in stocks also occur unintentionally owing to delays in production. An over-all increase of the quantities held in stock cannot always easily be secured, and the increase of the stocks in, for instance, the hands of the wholesalers will often be offset by a decrease of stocks with the producers, who cannot expand production fast enough to keep pace with rising demand, yet do not want to disappoint their customers. Similarly, when prices are falling or demand is declining, it may not easily be possible to reduce stocks of goods, which may, in fact, continue to grow temporarily.

We have mentioned above three main motives determining stock holding: (1) the motive of convenience; (2) the motive of speculation; and (3) the motive of economy. (The involuntary stock changes which follow the same pattern as the last might be described rather as unmotivated.) Whatever the motive, in each case, the desire to hold stocks has to be balanced against the cost in terms of interest, storage and handling. The cost factor is of importance in limiting additions to stocks held for convenience; but in the case of speculative stockholding in anticipation of rapid price movements, the possible gains and losses may be so large that any probable changes in the cost of keeping stocks would be of negligible importance in comparison. For instance in the 1919/20 boom in the United Kingdom "an interest rate of 45 per cent per annum, less the percentage costs of handling and storage, would have been required to take all profitability out of the mere holding of the average commodity on borrowed money—while the relevant short money rates at no time exceeded 7 per cent".¹

(d) *Durable Consumers' Goods.*

In Chapter I we drew attention to the importance of durable

¹ Cf. League of Nations: *Economic Fluctuations in the United States and the United Kingdom, 1918-1922* (Series L. of N. P., 1942. II. A.7), pp. 54-55.

goods in the total consumption of those countries in which the standard of living is high. The most notable case is the United States, where, according to the estimates of Dr. Kuznets, the average annual output of consumers' durable goods in the period 1919-38 was 7,100 million dollars and accounted for about 20 per cent of gross capital formation.

TABLE VI
*Output of Certain Consumers' Durable Goods in the United States
of America, 1929*
\$(000,000's)

Passenger Cars	2,799
Household Furniture	625
Household Furnishings	492
Automobile Parts and Accessories	408
Radio Apparatus and Equipment	388

In other countries, too, the motor car industry has been of great and increasing importance. In the United Kingdom, according to the preliminary results of the 1935 Census of Production, the gross output of motor vehicles and motorcycles was exceeded by that of only three other industries—building and contracting, mechanical and constructional engineering and coal mining.

The most important single factor affecting the output of consumers' durable goods is the level of consumers' incomes; a close correspondence is found between fluctuations in purchases of durable consumers' goods and movements of the national income, though the movements of the former are more violent (*cf.* Diagram I). As already explained, however, the causal relationship is not a simple one, but is influenced by the acceleration principle of derived demand. Because the goods are durable there are always stocks of them in the hands of consumers; and the demand for the services rendered is to that extent independent of the demand for new output. Thus in the United States the output of passenger cars for the domestic market fell from 5 million in 1929 to 1.4 million in 1932 (*i.e.* by 72 per cent), while the number of registrations fell only from 23.1 million to 20.9 million (*i.e.* by less than 10 per cent).

The durability of these goods tends in itself to lead to instability. An abnormally high demand in one year or a series of years, tends to lead, through a process of market saturation to a decline

in demand in subsequent years. In the same way, the longer that demand remains at an abnormally low level, the more likely it is to increase. This characteristic of durable consumers' goods has sometimes been an important contributing factor to the turning point of business cycles.

Changes in the distribution of income may be no less important than movements in the general level in influencing the demand for durable consumers' goods. In particular the disproportionate increase in profits and capital gains during booms constitute an important source of demand for this type of goods.

As already mentioned, the demand for durable goods is not dependent only on incomes, but is to a substantial extent supplemented by commodity or instalment credit. This is particularly true of the United States, where it has been estimated that in the period 1929-38 roughly between 40 and 50 per cent of all durable consumers' goods were sold on credit and that the percentage rose from 40 per cent in 1929 to 58 per cent in 1938.¹

Consumer credit outstanding has moved in close conformity with the business cycle, but there seems to be little evidence that changes in the price of consumer credit have played any significant role in initiating changes in the volume. On the contrary the supply appears to have been highly elastic in responding to changes in demand. Instalment credit has consequently accentuated economic fluctuations, enabling the demand for these goods to vary far more violently than incomes.

5. CONCLUSIONS

It is apparent that fluctuations in the various types of investment and demand for durable consumers' goods are a dominant factor in the problem of economic instability. We have seen that these fluctuations are largely dependent on the inescapable technological relationship between changes in the output of final goods and corresponding changes in plant and stocks of materials required for their production. The fluctuations in investment through their effects on incomes have repercussions on the demand for consumers' goods and cumulative spirals are likely to follow. Any policy designed to prevent periodic depressions must, there-

¹ Gottfried Haberler, *Consumer Instalment Credit and Economic Fluctuations*, National Bureau of Economic Research, 1942, p. 155.

fore, concentrate in the first place on attempting to stabilize or counterbalance these crucial fluctuations in investment; and in so far as these fluctuations are technologically unavoidable, attempts must be made to prevent the secondary repercussions and cumulative spirals.

CHAPTER V

DEPRESSIONS AND PRIMARY PRODUCTION

We shall find it necessary to give separate consideration in Section II of this Part of our Report to the problems facing the producers of primary commodities in time of depression because the trade cycle does not affect agriculture and mining—the two most important branches of primary production—in quite the same way as it affects manufacturing industry.

1. MOVEMENTS OF PRODUCTION AND PRICES

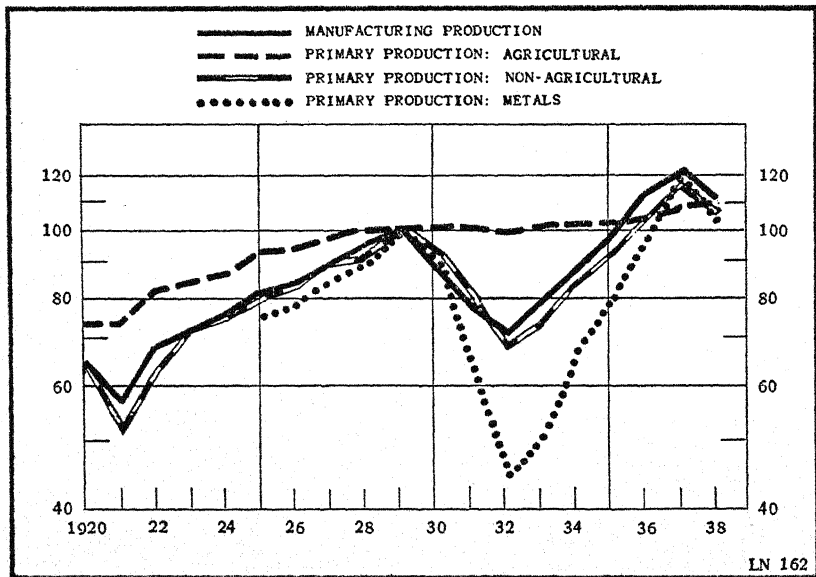
The common characteristic of cyclical instability in almost all forms of primary production is the wide movement of prices. But the behaviour of production is quite different in agriculture and in mining. Mineral production fluctuates to an even greater extent than does industrial production, whereas in agriculture the volume of output shows only minor cyclical variations. These movements are illustrated in the following diagrams.

Diagram VIII shows that, in the world as a whole, the physical

DIAGRAM VIII

Indices of World Production, 1920-38

1929 = 100



output of agriculture was not subject to any wide cyclical variations during the period 1920-38. In the great depression of 1929-33, agricultural production remained practically constant.¹ This stability is in marked contrast to industrial production, the curve for which reflects the ups and downs of general business activity—the deep slump of the early thirties, in particular, and the sharp but less prolonged recessions of 1920-21 and 1937-38. Non-agricultural raw material production shows the same fluctuations with about the same amplitude. But metals, which constitute part of this group, display the most intense picture of the business cycle; with swings twice as large as those of manufacturing production.²

In the absence of world price indices, it is unfortunately impossible to make a similar comparison for prices. The relative movements of prices of different groups of commodities in the United States, as shown in Diagram IX, may, however, suffice for purposes of illustration.

Prices of finished articles as a group, it will be noted, moved within a narrower range than those of agricultural products and metals.

The wide price fluctuations of raw materials are a matter of grave concern to states largely dependent on the sale of such products on the world market,³ for they affect at once the incomes of the producers of these products, and the terms on which foreign trade is conducted. In the case of agriculture, where production is relatively stable, price movements involve roughly proportional changes in income. The effect of any change in the prices of mineral products on income tends to be greater, because conditions leading to a fall in prices are likely to lead also to a fall in output and hence a more than proportionate fall in both individual and national incomes.

The larger cyclical swings of prices are initiated by changes in the economic activity in industrial states and hence in their demand for crude products. In agriculture, moreover, the income and pur-

¹ Stability in production did not imply an equal stability in consumption. The difference can be seen in the fluctuations in stocks (Diagram X).

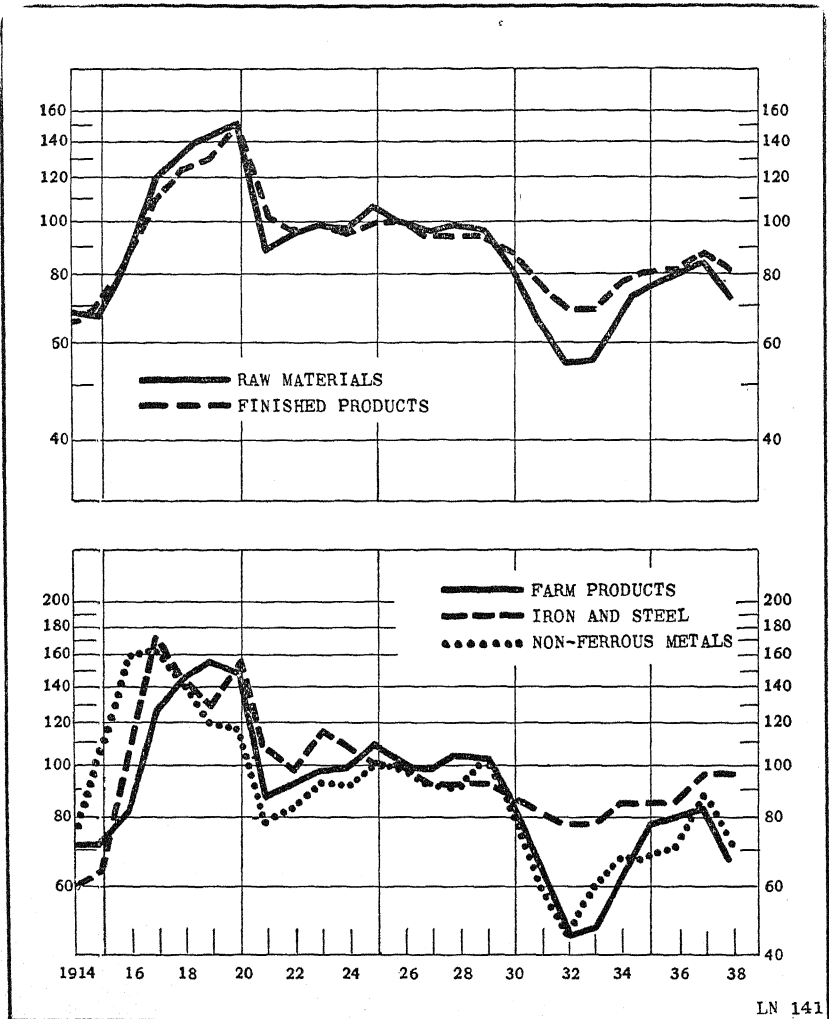
² The relatively moderate amplitude of the group of non-agricultural raw materials as a whole is due to the large weight (over 50 per cent) therein of fuels and power—coal, gas, petroleum, and electricity.

³ In this chapter we are not mainly concerned with European agricultural production, which is largely consumed domestically, and the protection of which at artificially high prices has been one of the factors making for overproduction in world agriculture.

DIAGRAM IX

Wholesale Prices in the United States, 1914-38

1926 = 100



chasing power of the farmers of a particular crop are subject to additional fluctuations due to the irregularity of crop yields. The American farmer, the Malayan rubber planter, and the Indian tea grower are at the mercy of wide price fluctuations, and the equally wide and sudden changes in their purchasing power give rise to

repercussions affecting industrial activity through fluctuations in their demand for manufactured articles. Thus a reciprocating cumulative process may be generated. The fluctuations in prices of primary products may further influence industrial production by causing disturbing windfall gains and losses on stocks held, thus imparting an additional element of cost instability to industrial employment and investment activity.

2. CAUSES OF PRICE FLUCTUATIONS

Owing to the heterogeneous nature of primary products, it is difficult to find an explanation of the erratic price movements to which they are subject which is of general validity. The League of Nations' index of primary production is based on no less than eighty-one different commodities, including, *inter alia*, six cereals, milk, oil materials, coal, electricity, thirteen textile fibres, sixteen metals and eleven other minerals. A few of these commodities such as coal, cement, and electricity, do not show the wide price fluctuations which we have taken as the most general characteristic of primary products. But these products, in addition to being frequently subject to private monopolistic or quasi-monopolistic, or official control, are to a large extent final consumers' products, and will therefore be disregarded in the following discussion. The remaining commodities fall into two different groups: agricultural and non-agricultural. The former group may be further subdivided into foodstuffs and industrial raw materials of agricultural origin. Substantial differences, both in supply and demand conditions, are found in the different groups.

(a) *Shifts of Supply and Demand.*

Wide price fluctuations are likely to arise on account of one or both of the two following causes:

(i) The occurrence of relatively large shifts of supply or demand, or of both.

(ii) The fact that the elasticities of supply and demand are both relatively low, that is to say, both consumption and production only react slightly to changes in price.

Shifts in the demand for staple foodstuffs are relatively slight. Supply, however, cannot be closely adapted to demand and is subject to fortuitous variation owing to climatic and other causes. .

The demand for raw materials is derived from the demand for the finished goods into which they are manufactured. Minerals are mainly used in the production of capital goods and durable consumers' goods, which, as we have seen in the last chapter, are subject to exceptionally wide fluctuations. Shifts in the demand for minerals, unlike the demand for foodstuffs, are therefore of considerable importance in determining price.

(b) Low Elasticity of Demand and Supply.

Both the demand and the supply of basic foodstuffs are inelastic; the demand is conditioned by physiological needs; the supply—and this is true of all agricultural products—is inelastic owing partly to the length of the period of production. Even in the case of annual harvests the economic “gestation period” may be longer than a year, owing to the system of rotation into which the various crops have to fit. With cattle the period is two to three years; with the coffee plant it is four years. A long time lag must therefore elapse between a change in price and the change in production which takes place in response to it. This lag may give rise, in the case of certain individual commodities produced under essentially competitive conditions, to a series of self-perpetuating price fluctuations of which the “pig cycle” is a well-known example. But it also helps to explain why at a time of general depression aggregate output tends to be maintained in the face of a slackening of demand.

The fact that the demand for raw materials is derived from the demand for manufactured goods causes that demand to be relatively inelastic. At each stage of production costs are added to the value of the raw material, and the value of the primary product becomes an ever smaller part of the price of the successive products. The greater the additional value incorporated in the intermediary stages the smaller will be the price elasticity of demand for the raw material in comparison with that for the final product. It follows that the elasticity of demand for most raw materials will be small. This tendency is enhanced by the interposition between producer and manufacturer of a long series of relatively rigid distribution costs: transport and handling charges, commissions, storage dues, specific duties and the like. These costs are frequently expressed

at a flat rate per unit of quantity. Their general effect is to make the demand facing the primary producer less elastic.

A further explanation of the maintenance of agricultural production and of the resulting slump in prices and farmers' purchasing power in a depression is to be found in the conditions of marketing and productive organization. The unit of production is small, producers are many and scattered, and concerted action is rare and difficult. The product is mostly standardized and undifferentiated. The individual producer cannot therefore influence the price by varying his scale of output; he has no incentive to restrict output at a time of falling demand. Since the farmer's direct money costs are usually small and can be compressed over short periods, prices can fall a long way before they affect his immediate production plans. The farmer has no alternative but to go on farming, and, in many regions, for instance, in the Canadian wheat belt, to go on growing the same crop. He may try to make up for the fall in price by working harder and increasing his output. Thus an excess supply may cause a further excess.

In mineral production, supply is generally more elastic. Production can be more easily curtailed or, within limits, be increased. Yet factors similar to those operating in agriculture—the difficulty of switching over to other products and the tenacity of small producers—make for an elasticity which is, on the average, still rather low, except where a strong monopolistic control has been achieved, as for instance in the case of tin.

(c) *Stockholding Policies.*

The third characteristic of primary commodities which influence price fluctuations is the fact that, with very few exceptions, they can be stored. Crude foodstuffs are often less perishable than manufactured foods. Thus wheat—at any rate certain varieties of wheat—keeps for years, whereas bread becomes stale in a day. In the case of industrial raw materials, it is mainly the fact that they are convertible to innumerable uses that renders them more easily stored than manufactured goods, which are subject to depreciation as a result of changes in productive technique, consumers' tastes, fashions, etc.

The stockholding of primary commodities, as of manufactured goods, is dependent on several quite distinct, and in some cases con-

flicting, sets of motives. In the first place, there is the technical consideration of assuring continuity of supply, which tends to induce merchants to keep a constant ratio between the volume of stocks and sales. We have discussed this policy in Chapter IV; if it is applied at every stage between manufacture and primary producer, the fluctuations in demand at the primary producer's end of the chain may become very violent. This effect seems to depend in part on the existence of separate firms in the successive stages of production and distribution, and may be modified by the modern tendency towards "vertical integration" or amalgamation of firms in successive stages of production (*e.g.* iron mines, blast furnaces and steel mills).

Apart from this purely technical factor, stock policies are influenced by changes in prices, or more strictly, by expectations of future price changes. Here again, two entirely different cases must be distinguished, depending upon the type of expectations regarding future prices set up by changes in prices that have actually occurred.

The first type of response is characterized by the normal reaction of farmers when a bumper crop appears and depresses the price. In such a situation it is customary to hold back part of the supply in anticipation of higher prices in subsequent years, when crops will be normal or short. Similarly, an excess demand for minerals expected to be short-lived will be met by letting stocks run down, and a subnormal demand by producing for stock. "Seasonal speculation" works in the same way.

This form of speculation has a stabilizing effect on prices. It is based on the expectation that prices will return to an equilibrium level and itself helps to bring about this result. It could never make prices absolutely stable, since the expected price differences must be sufficient to cover the costs of storage and the interest on capital. But the existence of this type of speculation undoubtedly tends to reduce actual fluctuations in prices of storable commodities.

If this form of speculation were strong enough we should expect relatively stable prices of primary products, apart from exceptional cases where stocks of particular commodities ran out owing to a very large temporary shortage, or storage capacity became insufficient owing to a sequence of bumper crops. These exceptional price movements would affect only individual commodities, except

in so far as climatic conditions influenced all alike, which does not usually happen, as can be seen by the relative stability of the index of world agricultural production as a whole.

In fact, however, price fluctuations are wide and generally affect most raw products simultaneously. This can be seen from the following table, which compares the highest monthly average with the lowest preceding and succeeding average price of sixteen commodities during the three years 1936-38.

TABLE VII
Variability of Prices of Primary Products, 1936-38

Commodity (and Market)	Dates of High and Low Points			Percentage Changes	
	1st mini- mum	Maxi- mum	2nd mini- mum	1st mini- mum to maximum	Maximum to 2nd minimum
	1936	1937	1938		
Wheat (Liverpool)	June	Apr.	Dec.	+ 75	—60
Maize (Chicago)	Mar.	Apr.	Oct.	+ 133	—77
Rice (London)	Mar.	Oct.	Apr.	+ 33	—14
Sugar (London)	Sept.	July	Apr.	+ 48	—24
Tea (London)	June	Sept.	Nov.	+ 35	—24
Coffee (New York)	Apr.	June	Apr.	+ 49	—49
Cocoa (New York)	Apr.	Jan.	Dec.	+ 129	—62
Beef, chilled (London)	Mar.	May	Mar.	+ 45	—17
Butter, Danish (London)	Apr.	Oct.	Mar.	+ 46	—23
Wool, Merino (London)	Sept.	July	Nov.	+ 45	—42
Cotton (New York)	Mar.	Mar.	Nov. ('37)	+ 27	—45
Rubber (London)	Jan.	Mar.	Mar.	+ 91	—60
Timber (Sweden)	Jan.	Apr.	Oct.	+ 57	—33
Copper (London)	Jan.	Mar.	June	+ 100	—48
Tin (London)	June	Mar.	Apr.	+ 66	—45
Lead (London)	June	Feb.	May	+ 99	—53

Taking the sixteen commodities together, the average percentage rise from the first minimum in 1936 to the maximum in 1937 amounted to 67 per cent. The subsequent average fall to the second minimum (which, with the exception of cotton, was reached in 1938) amounted to 42 per cent. These fluctuations are clearly connected with the general business cycle, and it is this fact which gives rise to a second, destabilizing type of speculation.

Whereas in the case of price changes due to abnormal harvests speculators expect prices to come back to normal relatively soon, in the case of price movements due to the business cycle, speculators may expect prices to continue for several years in the same

direction. In the latter case, therefore, speculators buy when prices are rising and sell when prices are falling, thereby accentuating the movements on which their expectations are based.

A close inspection of Diagram X reveals these two tendencies in stockholding. A pronounced negative correlation can be observed between prices and stocks, both for the seven individual commodities, and for the combined index; but there is a definite difference in behaviour before and after 1929. The period from about 1925 to 1929 was one of over-production of many important primary commodities. At the time, however, the difficulties were regarded as temporary and it was thought that short crops and increasing demand would soon bring relief. In this expectation stocks were accumulated which sustained the price level. Prices fell, but not with extreme rapidity, on the average by about the same percentage that stocks rose. After 1929, stocks indeed continued to rise; but the price fall necessary to induce traders to accumulate them was much steeper. Though prices rose from 1932 to 1934, stocks did not decline. The rise was seen as part of the business cycle upswing, when "holding on" was bound to be profitable. When the 1937 boom occurred, however, it appeared that traders thought the price rise had reached its limits. Stocks were liquidated in anticipation of a price fall; and the large supplies that came onto the market in this way are generally regarded as having been an important factor in producing the sharp price fall which in fact took place.

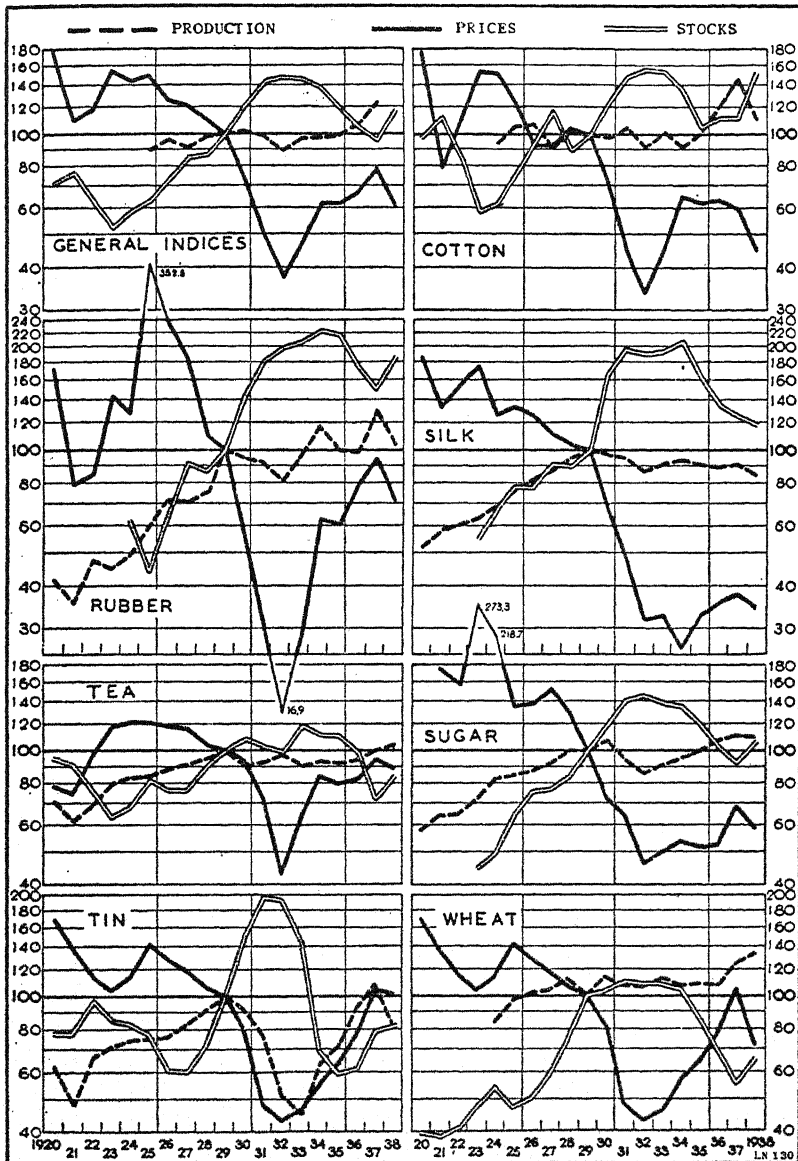
3. LONG-RUN EXCESS CAPACITY IN PRIMARY PRODUCTION

The difficulties created by the instability of the prices of primary products have been complicated by the persistent state of disequilibrium in the structure of world agriculture since the war of 1914-18, to which attention was drawn in Chapter I. The increased agricultural protection in Europe after 1929; the extensive if not uniform improvements in the methods of agricultural production; and the long-term decline in the per capita consumption of certain basic foodstuffs associated with the rising standard of living; all these factors combined to produce a chronic situation of surplus capacity in world agriculture which superimposed a downward trend on the price fluctuations resulting from the industrial business cycle.

DIAGRAM X

World Production, Prices and Stocks, 1920-38

1929 = 100



Note. The "General Indices" represent weighted averages of the seven individual commodities shown in this diagram. Prices are dollar prices.

Though to a lesser extent, similar causes tended to lead to over-production of certain minerals and of rubber. The increase in capacity was here induced not so much by the last war as by the enormous rise in prices shortly after the war. It may be noted in this connection that the prices of tin, zinc, lead and rubber declined consistently from about 1925 to 1932. Minerals, too, were affected by the drift towards autarky. The synthetic production of petroleum, as of rubber, fibres and nitrates; the mining of low-grade home ores; the intensive drive to recover and collect scrap; the replacement in some countries of coal by electricity; these were all measures designed to counteract the incidence of the accidental distribution of minerals throughout the world. In addition, the output of some minerals, such as tin, has been affected by marked improvements in the art of extraction; and of others, such as coal, by changes in manufacturing processes leading to important economies in their use.

CHAPTER VI

INTERNATIONAL SPREAD OF BOOMS AND DEPRESSIONS

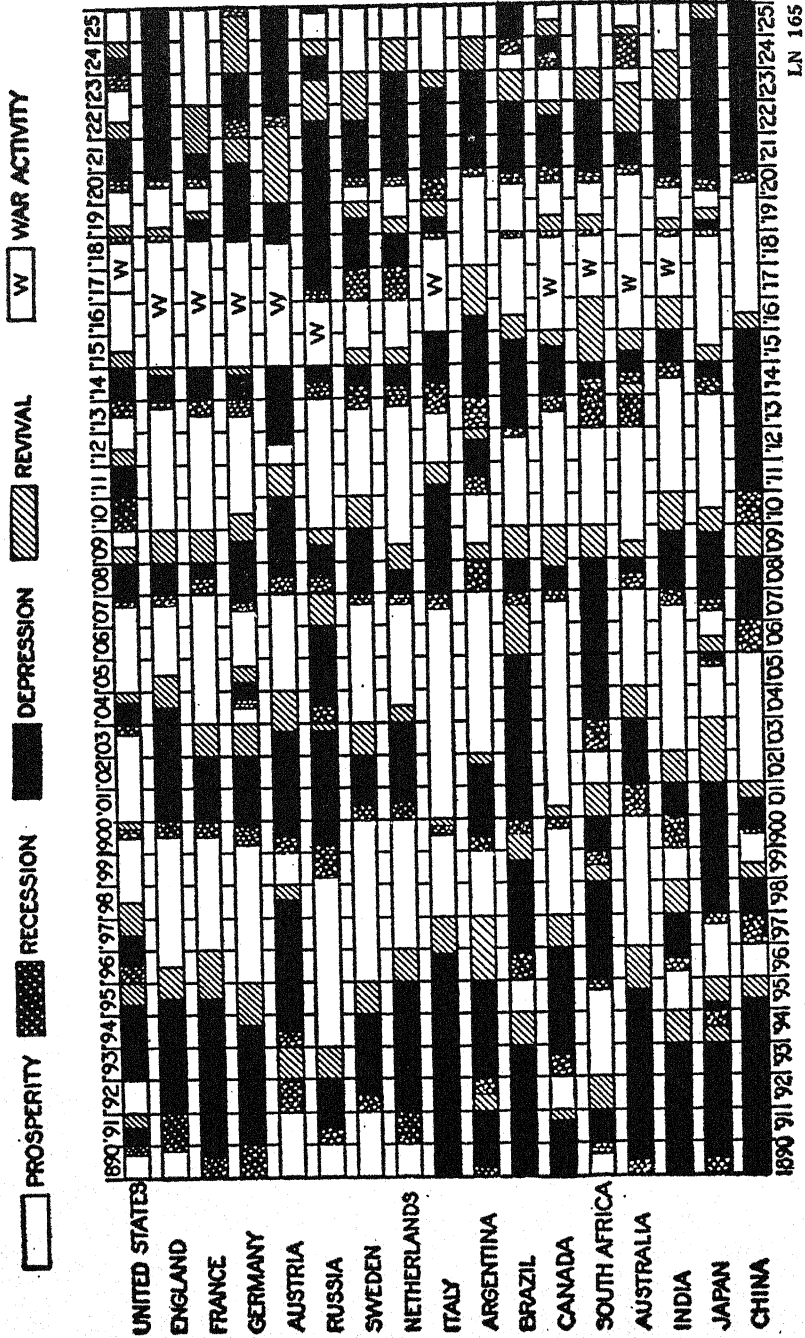
1. INTERNATIONAL SYNCHRONIZATION OF BUSINESS CYCLES

It was suggested in the previous chapter that one of the main causes of depressions in primary producing countries was the falling demand for their products in industrial countries. This is only a particular case of a more general process whereby depressions tend to spread from one country to another. Parallel movements in business conditions in industrial countries are no less common. In the absence of comprehensive production indices for the last century, this parallelism can best be seen from a comparison of business annals in different countries. The results of an evaluation by the National Bureau of Economic Research of the annals of a number of countries in terms of four states of business activity: depression, recovery, prosperity and recession, are shown in Diagram XI on the following page.

Despite irregularities, the general tendency towards parallelism is clear. The intensity, timing and importance of cyclical movements varies from country to country and at different periods; but it was the exception rather than the rule for any country to remain unaffected by major booms or depressions occurring elsewhere.

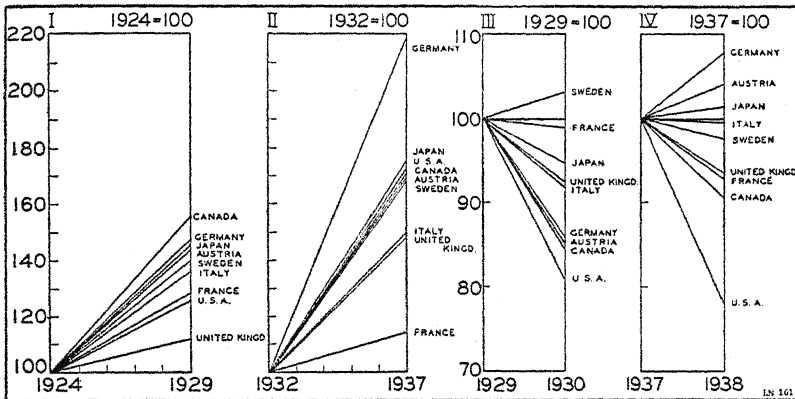
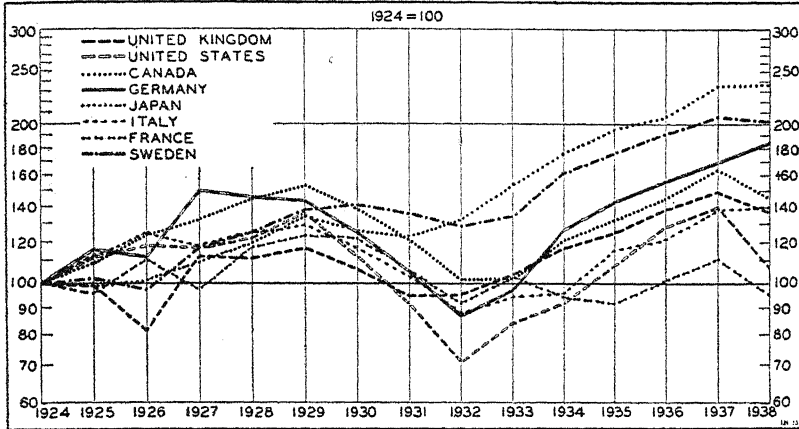
After the Great Depression of 1929-32 the tendency towards synchronization was less pronounced. This can be seen from a comparison of the movements of the production indices for the last two business cycles in Diagram XII. The increase in industrial production in these countries in the upswing of 1924-9 ranged from 12 to 55 per cent while in the corresponding upswing from 1932-7 the increases varied from 14 to 120 per cent. An even greater difference is evident between the depressions of 1930 and 1938 when war and the preparation for war in certain countries exercised a dominant influence. In 1930 production fell in all these countries except Sweden, whereas in 1938 production increased substantially in Germany, Austria and Japan, reflecting war preparations, while it was falling sharply in the United States, Canada, France and the United Kingdom.

DIAGRAM XI¹
Conspectus of Business Cycles in Seventeen Countries



¹ Adapted from *Business Annals*, Willard Long Thorp and Wesley C. Mitchell, 1926 (National Bureau of Economic Research, Inc., New York), Chart VI, pp. 94-95.

DIAGRAM XII

Indices of Industrial Production in Various Countries, 1924-38

2. DIFFERENTIATING FACTORS IN INTERNATIONAL TRANSACTIONS

We have already described the mechanism by which an increase or decrease in spending in one part of the economy of a single country spreads through the change in income, consumption expenditure and induced investment to other parts of the economy. As we shall show in later sections of this chapter the same sort of mechanism explains the international spread of business cycles;

but this mechanism is modified by certain factors which differentiate internal from international trade.¹

The four main differentiating factors are: (1) the greater transport costs, tariff barriers and quantitative trade restrictions; (2) greater immobility of labour; (3) autonomous currencies; (4) probably most important of all, greater sensitivity of capital.

Transport costs, like tariffs, act as a barrier limiting the volume of international trade, and, since trade is one of the main channels through which booms and depressions spread from one country to another, they tend at the same time to limit the tendency toward parallelism. Countries which are particularly isolated or maintain a high degree of self-sufficiency are likely to be less affected by business fluctuations abroad than those in which international trade plays a more important role.

Immobility of labour is a second factor limiting the international as well as the internal spread of cycles. The areas of localized unemployment which may persist within a country despite boom conditions existing in other parts are due to this immobility. If labour were able to move freely from the depressed to the booming areas, this would help to check both depression and boom and keep conditions in the different areas more closely in step. The same influence operates internationally, and the great influence exerted by official and cultural impediments to the international mobility of labour is one reason for the discrepancies between conditions in different countries.

The effect of the third differentiating factor, the existence of autonomous currency systems, depends on the relationship which exists between the currencies of different countries. If currencies are maintained at fixed rates under the gold standard the situation differs little from that within a single country. Price changes of individual commodities, reflecting fluctuations in demand or conditions of supply, are likely to be in the same direction internationally and internally. They are likely also to vary similarly in degree, except in so far as the changes of individual prices are damped down or accentuated as a result of the greater transport costs or tariffs or of other factors peculiar to foreign trade noted above. These generalizations must be modified in a minor degree

¹ Cf. Gottfried Haberler, *Prosperity and Depression* (League of Nations), Chapter 12.

to the extent that slight variations in exchange rates are allowed to occur between gold import and export points. If, on the other hand, exchange rates are not fixed at all, but allowed to fluctuate freely, changes in prices of individual commodities reflecting changes in business conditions in one country may be reversed in other countries. When a country permits its exchange to depreciate, for example, the internal prices of export commodities may not reflect fully or at all a fall in prices for the same commodities in other countries. There will occur, however, an increase in prices of commodities that are imported, even commodities whose prices are unchanged abroad. The degree of change in prices both of imported and exported commodities relatively to prices of the same commodities abroad will depend on the degree of fluctuation in the exchanges. Consequently, in the case of fluctuating currencies as well as in the case of currencies with fixed exchanges, repercussions of changes in business conditions within a national market are transmitted internationally in greater or less degree depending on the commodities immediately affected, the economic structures of the countries involved and the place of these commodities in these economies. The repercussions on different commodities, however, may be strikingly different when exchanges are allowed to fluctuate freely from those that would ensue under fixed exchanges.

As we have noted, the fourth factor, namely, the greater sensitivity of capital in international markets as compared with internal markets, is probably of particular importance in the international spread of business cycles. Our analysis throughout this Part of our Report has indicated the crucial and fundamental role played by fluctuations of investment in the ebb and flow of business activity. It has shown that when investment is stable, income, employment and production are most likely to be stable. It has also shown that investment in sufficient volume to absorb the margin between income and consumption is a condition of full employment. The implications of these findings have peculiar significance in the field of international economic relations where, owing to the wide differences in the rates of consumption, savings and industrialization in different countries, the marriage of potential savings with potential opportunities for investment has frequently been effected through the mechanism of the international capital market. The stability of the economies of many countries, particularly countries

in an early stage or rapid process of industrialization, has been dependent on an inflow of investment from outside. Even in highly industrialized countries, the rate of investment in certain individual industries or enterprises closely affiliated with foreign sources of capital may depend on investment decisions reached outside the national boundary. The stability of capital-exporting countries with high rates of saving has also been dependent on the recurrent appearance of new opportunities for investment abroad.

There is probably no field of international economic relations where the existence of a national boundary more sharply differentiates an international economic transaction from its national counterpart than that of investment decisions. All investment decisions are subject to a greater or less degree of hazard or uncertainty, owing to the impossibility of accurately forecasting future events. In the case of each class of international investment decision, however, as compared with its domestic equivalent, these uncertainties are always increased by the existence of two sovereignties, the jurisdiction of two systems of law applied by different systems of courts, and the presence of two autonomous currencies. They are also likely to be accentuated by physical remoteness and less intimate contact with local conditions as between borrower and investor. It is almost inevitable, therefore, that decisions to invest abroad are even more sensitive to the whole range of factors that make for the ebb and flow of business activity than decisions to invest at home. Unless these factors are counteracted, therefore, the flow of investment spending on international account is always in danger of being highly cyclical or erratic in its volume, even more so than that on domestic account, thus acting powerfully to spread both booms and depressions across national boundaries.

3. THE INTERNATIONAL BUSINESS CYCLE AS REGISTERED IN THE BALANCE OF PAYMENTS

Since all international spending through which booms and depressions are transmitted from one country to another involve exchange transactions, they affect the international balance of payments. To observe the process by which business fluctuations spread internationally, we have only to look at the effects of a boom or depression in one country on the different elements in the balance of payments. Statistical material adequate to reveal the

nature of the problem and to indicate the relative magnitudes involved was becoming increasingly available prior to the outbreak of the present war, as country after country endeavoured to expand the analysis of its balance of payments problem by securing more accurate estimates of all of the major categories involved. This work, which has been concentrated mainly on the "invisible" items as contrasted with statistics of imports and exports which have long been available for most countries, has served to draw increasing attention to the importance of fluctuations in the capital items on cyclical changes in the gold and foreign exchange position. This importance is due to the sensitivity of international investment noted above. If any generalization about the problem here under consideration can be made from a scrutiny of the more adequate balance of payments statistics now available, it is that the international spread of booms and depressions is particularly related to changes in imports or exports of raw materials and food-stuffs, and to changes in international investment decisions. The highly cyclical behaviour of international spending on raw materials and of international decisions to invest consequently become particularly critical elements in the international spread of booms and depressions.

Table VIII presents an analysis of the balance of payments of the United States over the seventeen-year period, 1923-39, designed to bring out the particular individual items in the balance which registered the greatest annual fluctuations over the period as a whole. It is through these items that major changes in the international economic relationships of the United States during the period were expressed. They indicate, therefore, the magnitude of individual elements of instability during a period of great changes, the elements through which the major readjustments caused by booms and depressions, as well as those resulting from structural changes or erratic factors, were spread internationally during the period. It should be noted that because the figures are averages of fluctuations of individual items over a long period, the table does not indicate the result of a particular fluctuation at any particular moment. It does not indicate, for example, the extent to which the variations in the individual items, such as the trade and investment items, were so synchronized in direction as to reinforce or offset each other at different periods. It may be stated in this connection,

TABLE VIII

*Impact on International Currency Markets of Individual Items
in the United States Balance of Payments, 1923-39¹*

Annual Averages in \$(000,000's)

<i>Section I</i>		<i>Section II</i>	
Average year-to-year changes (plus or minus) in imports and other items regularly providing dollars:		Average year-to-year changes (plus or minus) in exports and other items regularly absorbing dollars:	
Imports of crude and semi-finished products	378	Exports of finished products ^b ..	275
New loans to foreign countries ..	185	Exports of crude and semi-finished products ^b	188
Imports of finished products ..	130	Receipts of interest and dividends	80
New direct investment abroad (net) ^a	77	Receipts on amortization	49
Imports of silver	61	Receipts on shipping and freight	85
Payments for shipping and freight	52	Government aid and settlements	28
Payments of interest and dividends	44	Net receipts on account of various minor items ^a	20
Travel expenditure abroad ...	43	Travel expenditure in the United States	14
Personal remittances abroad ..	20	Sales of silver	11
Government aid and settlements	15	Personal remittances to the United States	6
Miscellaneous government payments	6	Miscellaneous government receipts	2
Institutional contributions	5		

Section III

Average balances of all remaining items in the balance of payments (sometimes providing, and at other times absorbing, dollars):

Net gold movement	698
Foreign holdings of short-term funds in the U.S.	456
Net purchases and sales of outstanding securities	264
Unexplained items	260
American holdings of short-term funds abroad	176

^a The figures against these items represent the changes in a balance which was positive in certain years and negative in others.

^b Not including re-exports (which could not be distributed between items II A and B). The average year-to-year change in total re-exports was 11 million dollars.

¹ In attempting to measure the impact of various items on the balance of payments, distinction has to be made between items which give rise to regular "normal" inward or outward payments, such as imports or exports of goods or services, and other items such as short-term capital movements and banking transactions in gold, which may either provide or absorb funds, depending on their direction. In a situation without disturbing forces, most of these latter items would approach zero. In the former case, *i.e.*, of items representing "normal" in- or out-payments, disturbance is measured by the magnitude of any *change* (plus or minus) in the amounts involved. In the latter case, the impact toward change in a given year may be taken as proportionate to the magnitude of the balance itself, which represents the deviation from the "normal" situation in which the balance would approach zero. To illustrate, the magnitude of the impact abroad of economic developments within the United States in any year would be measured (1) in the case of commodity imports, by their aggregate change (plus or minus) as compared with the preceding year, but (2) in the case of gold, by the absolute net gold movement in that year.

however, that a scrutiny of these individual movements year by year indicates that all too frequently the instability registered in the high variability of the trade figures, particularly those covering primary commodities, was accentuated by the direction of movement of the various capital and other items.

Sections I and II of the table indicate the variations of the major categories of economic transactions that are regular and persistent in their impact on the balance of payments, either supplying dollars through American purchases of commodities and services abroad or absorbing dollars through foreign purchases of American commodities and services. In the table they are arranged in decreasing order of the size of their average variations over the period as a whole. The central role in the ebb and flow of international trade played by fluctuations in the aggregate money demand for prime commodities on both the import and export side is obvious. The wide variations in the various capital items covered, which were in fact very unstable, are also brought out strikingly in these sections of the table.

Another extremely important item shown in Section II is "Exports of Finished Products from the United States", the fluctuations of which over the period exceeded those of the exports of crude and semi-finished products. These wide fluctuations were due to the fact that United States exports of finished manufactures were heavily weighted during the period by such durable commodities as automobiles and appliances, which not only are subject to large cyclical fluctuations in demand but also were singled out particularly for restrictive official action in the disturbed international trade conditions of the 'thirties. To some extent, however, they simply reflect in the trade figures the cyclical variability of capital investment, since a certain proportion of exports of capital funds are taken by the borrowers directly in the form of exports of durable capital equipment.

Section III of the table shows the average annual balances of all other items in the balance of payments: gold movements, changes in short-term financial balances, net trading in outstanding securities, and "unexplained" movements. The movements of these items would be expected to be considerable, since they include flows of funds required to offset the aggregate changes in the trade and other items included in Sections I and II. Their size during

the period covered, however, is to be explained in part by the fact that they reflect in many cases such highly destabilizing capital movements as (1) foreign speculation in the American stock market in the late 'twenties; (2) the huge withdrawals of United States balances abroad during the crisis of the early 'thirties, and (3) during the late 'thirties a flight of capital in the form of "hot money" to the United States. The exact nature of the transactions which account for the magnitude of the heading "unexplained items" is unknown; but it is probable that they are closely associated with the flight of capital from exchange controls that were imposed during the 'thirties.

These figures, of course, apply solely to the balance of payments of the United States; but the generalizations which emerge from them would appear to hold wider validity. This becomes particularly clear if account is taken of the fact that international trade in primary products accounts for sixty per cent of the whole of international commodity trade, and of the fact that the United States exports and imports of capital constitute a preponderant proportion of total international capital transactions.

It is evident, therefore, that there is nothing strange in the simultaneous appearance of a boom or of a depression in widely scattered sections of the globe. We have indicated in an earlier chapter that the ebb and flow of business are strongly influenced by the economic environment of institutions and habits in which they take place, and are particularly characteristic of an individualistic economy that has progressed far in the accumulation of capital facilities and in the provision of a high standard of living. We have noted the strategic role of investment in the initiation of these recurrent ebbs and flows and the manner in which small variations in aggregate demand for primary products are reflected quickly and in magnified form in the aggregate income of producers of these products. These factors are particularly important in international economic relationships, partly because investment decisions are very sensitive to factors introduced by the existence of national boundaries. It follows that any country whose economy is intimately dependent on foreign investment or whose trade is greatly dependent on primary commodities will be seriously affected by swings of business arising outside its own borders.

4. EFFECT OF CHANGES IN NATIONAL INCOME ON IMPORTS

But a boom in any country, even when it is due entirely to internal factors, for instance, an increase in domestic investment, will usually exert an immediate influence toward expansion outside its borders, particularly if exchange rates are fixed. Unless there is official intervention to stop it, part of the increase in aggregate income within a country that accompanies an expansion of investment will probably be spent directly on increased imports of finished products; but, with very few exceptions, a much larger part is likely to be spent on finished domestic commodities, fabricated in part out of imported primary products. The increase in domestic investment will thus give rise to an increased demand for imports, the extent of the increase depending on the size and type of the country concerned, the technical possibilities of substitution between imports and domestic products, legal barriers to importation such as tariffs, quotas, etc., and similar barriers imposed by cartels. It will also depend, of course, on the magnitude of the increase of internal investment within the country in relation to its economic structure, the level of economic activity prevailing at the time and the size and distribution of the national income.

It is important to bear in mind in this context that the proportion of such an increase in domestic income which will be devoted to additional imports may be very different from the proportion of the total national income which is spent on imports; it is the former proportion which is mainly relevant in the spreading of booms from one country to another. A country which is highly industrialized and which imports mainly necessities will devote a relatively large part of its whole national income to imports, but only a small part of any *increase* in incomes. Countries, such as the United States, which are more self-sufficient may have a lower ratio of imports to national income as a whole; but if their imports consist mainly of industrial raw materials and luxuries, a much larger proportion of any *increase* in income will go to increasing imports. The United States, being large and relatively self-sufficient, has a low ratio of imports to national income as a whole, though in good times her imports are very large, in terms of world trade. Owing, however, to the high proportion of raw materials, luxuries and specialized products among her imports, the volume of imports as a whole is extremely sensitive to changes in the level of domestic

activity and income. Hence, business fluctuations in the United States have exercised a much larger influence on other countries than might have been expected for a country in which foreign trade played so small a role in the economy as a whole.

Thus the influence of changes in business conditions within a country on business conditions abroad, to the extent that it is effected through its imports, depends not only on the amount of its imports, but also on the extent to which these imports increase or decrease when there is a change in domestic activity. This relationship between changes in domestic income and resultant changes in imports, moreover, is not constant but may alter as a result of changes in consumers' tastes, of tariff changes or the operation of exchange control, or of technical changes affecting the relative efficiency of domestic products and imports.

Apart from such structural alterations, the effect of income changes on imports will vary with the different phases of the business cycle. This is a consequence of the changes in income distribution and the structure of production which we have seen to be normal features of the cyclical process. If a country imports mainly luxuries or capital goods, for which the demand is unstable, changes in domestic conditions will have a much greater effect on its balance of payments and hence on conditions abroad than will changes in a country with a trade identical in value but which imports mainly necessities.

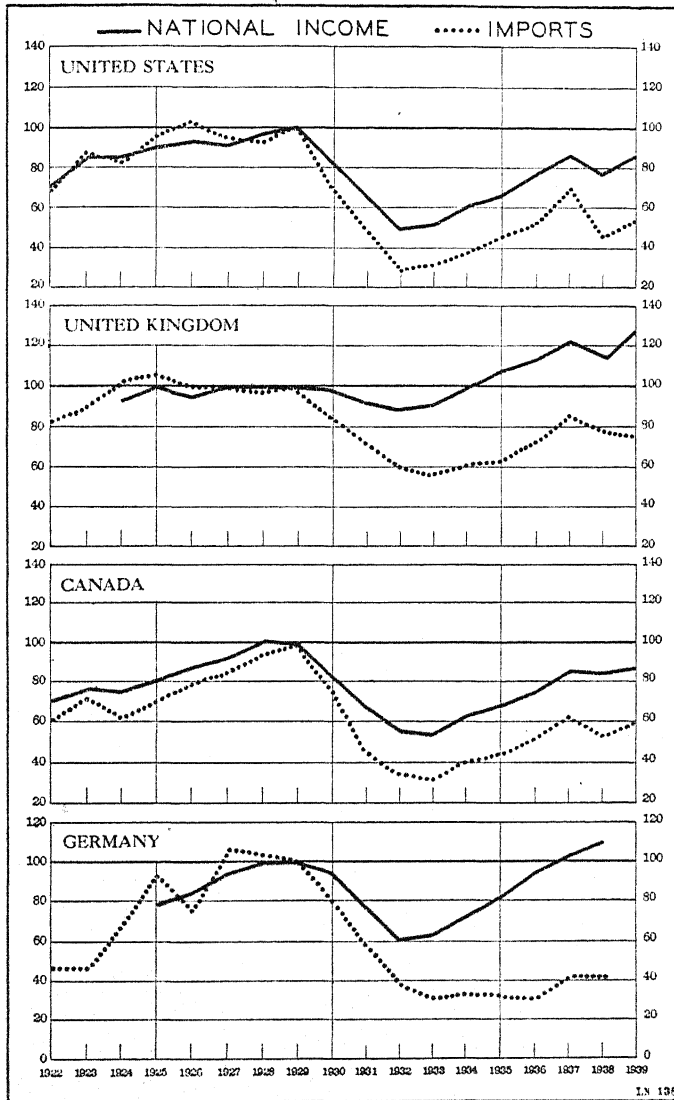
The relationship between changes in national income and imports in the United States, United Kingdom, Canada and Germany during the past two decades is shown in Diagram XIII. A fairly close correspondence can be observed in the United Kingdom and Canada and, apart from the year in which a general tariff was introduced, in the United States, and also in Germany before the imposition of exchange control.

5. EFFECT OF DOMESTIC EXPANSION ON EXPORTS

The spread of business revival out of the country in which it is initiated, by means of an increase in its imports, tends to create a more favourable market for its exports. Other countries receive an expansionist impulse which will increase consumers' demand for commodities, some of which may be imported as finished articles and many more of which will probably be manufactured at home

DIAGRAM XIII

*Movement of National Income and Imports, in United States,
United Kingdom, Canada and Germany, 1922-39*
(1929 = 100)



SOURCE: *The United States in the World Economy*, United States Department of Commerce.

in part or in whole from foreign raw materials. The international effect of this demand will depend, *inter alia*, upon the factors we have already mentioned when discussing imports, namely, the level of economic activity, the size and distribution of the national income, the size and structure of the country, the technical possibilities of substitution between imports and domestic products, legal barriers to importation such as tariffs, quotas, etc.

Some of this expansion will probably be reflected back directly to the country from which the impulse started in the form of an increased demand for its products, where it will give an additional impulse to the expansion already under way. The remainder will flow to other countries, where it will initiate the same process over again, the extent of the response always depending upon the technical conditions mentioned above; but again part of this response may revert to the country of original impulse. Thus the process by which an initial expansion in any country tends to lead to further expansion operates internationally in much the same fashion as internally. In the international field it will probably be reflected, at the very least, in an increased import of raw materials, which in its turn will set in motion forces tending also to increase exports. As in the internal field, the cumulative effect of this process rests on the fact that recipients of additional increments of income are likely to re-spend them at least in part. Inasmuch as a part of this re-spending favours the building up both of imports and subsequently of exports, the tendency to expand operates by diminishing increments until a new balance of trade has been achieved at a higher level of income in both countries.

It is especially important to note that these processes are not simultaneous but involve a lag. In the case cited above, the country of initial expansion would experience a relatively quick increase in its demand for imports, but its exports would not tend to expand until these increased imports had exerted an effect upon the internal level of incomes of the countries from which they were derived. In these latter countries, on the other hand, the lag would be reversed. In their case, exports would increase first and would tend to be followed after a lag by an increase in the demand for imports. The size and duration of this lag will depend upon all of the particular factors mentioned above. It will probably be

very short, if various technical conditions in the countries affected are propitious, but under certain circumstances it may be very long, as, for example, when trade takes place between two countries, in one of which an increase in the level of incomes leads to a large immediate demand for goods in whole or in part of foreign origin, while in the other the demand for such goods is relatively small.

It may also become difficult to achieve even an eventual equilibrium if the two countries are very unequal with respect to the dependence of their industry on export markets and in the types of products which they customarily import. A country, for example, that was highly self-sufficient and imported mainly those foodstuffs and raw materials for which its demand remained relatively constant as between prosperity and depression would find it very difficult to eliminate the lag and achieve cyclical equilibrium if its exports consisted mainly of capital goods, durable consumers' goods and "high standard of living goods" generally, for an internal expansion in such a country would find only a small expression in its import activity. Even this small increment, however, might lead to a sufficient revival among its foreign customers to stimulate very much larger orders for exports in the form of "high standard of living goods".

6. EFFECT OF INTERNATIONAL INVESTMENT

This lag will tend to be smaller, though it will not necessarily be eliminated, if the initial impulse toward expansion proceeds, not from internal investment within a country but as a result of an act of productive international investment. As a rule international productive investment, particularly long-term investment and direct investment, involves more than the provision of funds; it is likely also to involve on the one hand the placing of orders for plant and equipment in one or more industrialized countries and, on the other, expenditures in the receiving country for their installation. The operation, therefore, is of a type that is likely to stimulate initial expansion simultaneously in at least two countries and thus through its effect upon their incomes to set in motion at the same time within each of these countries forces that lead cumulatively to increased foreign trade. In these circumstances the initiating impulses for exports and imports more nearly coincide and the

subsequent development of a lag would be more likely to reflect the specific technical conditions affecting the nature of the foreign trade of the country concerned.

All of the cumulative processes described above by which an initial impulse toward expansion or contraction is transmitted internationally through changes in the volume of foreign trade are further reinforced by the tendencies toward investment or disinvestment which they may stimulate. An increased demand for exports in any country is likely to be reflected in greater opportunities for the investment of capital, either foreign or domestic, not only in the export industries themselves but in industries supplying the home market. The scale of this additional investment will depend of course on the existing capital equipment and the degree of its utilization, but even at the bottom of a depression when there is ample unused capacity, an increased demand for exports may well lead to an acceleration of plant replacement. When the expanding demand for exports impinges on an economy enjoying a fairly high level of employment, the range of opportunities opened for further investment will be much broader, particularly if the country is still in a relatively rapid state of development. These opportunities will lead both to increased investment from domestic funds and increased demands for foreign capital, and the spending of these funds will operate to expand further the demand for imports, both imports for general consumption and imports of specialized productive equipment. This factor consequently may be very powerful towards the top of a boom, and, taken in conjunction with the fact that potential investors are more inclined to minimize the risks of foreign investment when the exports of the country in which they contemplate investing capital have shown a rapidly rising trend, accentuates the cyclical incidence of foreign investment.

Investment and disinvestment in stocks of primary commodities also exert important effects on the international spread of the business cycle. We have described elsewhere the recurrent waves of demand to which primary commodities are cyclically subject, the magnified effect of these waves on the prices of these commodities and on the incomes of producers and the market mechanism which tends to shift during the course of the business cycle. It is sufficient to point out here that this highly cyclical behaviour is a

peculiar characteristic of international economic relations, because countries are highly specialized in the production of primary commodities, and these commodities constitute the preponderant element in international trade.

7. CLOSING THE GAPS IN THE BALANCE OF PAYMENTS

The foregoing analysis has indicated the manner in which recurrent waves of activity and depression, if left to themselves, tend to spread from country to country. At the same time our analysis has made it clear that the spread of those waves from area to area is a process that necessarily takes time. A perfect international synchronization of cyclical movements would be conceivable only if these movements arose in the different countries spontaneously and simultaneously. Since in fact there is nothing to ensure such spontaneous and simultaneous generation of parallel cyclical changes, synchronization has never been perfect but has always involved more or less considerable lags.

These lags are associated with gaps in the balance of payments. We need merely recall the simple example used earlier in this chapter: namely, the case of a favourable impulse to domestic investment in a given country, leading to an increase in national income and hence imports, a rise in activity in the export and later also in the home-market industries of the country supplying those imports, a rise in national income and demand for imports in that other country, and finally an increase in the exports of the given country from which the impulse originated. The original impulse gives rise almost at once to a gap in the balance of payments due to the increase in the demand for imports in the country first mentioned. This gap is a reflection of the lag of the second country behind the first in the process of cyclical change; it tends to be closed as and when the lag disappears through the progressive spread of increased income and expenditure from the export to the home-market industries of the second country. At the end of the process there is an increase in demand for the exports of the country of original impulse, tending to balance the initial rise in imports. Equilibrium in the balance of payments will have been restored at a higher level of trade.

In the meantime, however, something must be done to fill the

gap, if exchange stability is to be maintained. It has been the traditional function of gold supplemented by foreign exchange reserves to fill gaps in the balance of payments including the gaps arising in the international spread of cyclical changes in business activity. The experience of the 'thirties has shown that the use of gold as a medium of international settlement for this purpose need not be confined to a system of the traditional gold-standard type.

The traditional gold-standard system which functioned successfully before 1914 relied not only on gold and foreign exchange reserves to fill gaps in the balance of payments; it relied to a large extent also on a delicate mechanism of private short-term capital movements. When a deficit arose in a country's balance of payments, an inflow of foreign liquid funds could usually be relied upon to cover it at least in part, and thus to take some of the strain off the country's gold and exchange reserves. The two main conditions which induced short-term funds to behave in this equilibrating manner were: (a) slight variations of the exchange rates within the gold points, which made it profitable to acquire bills or balances in any currency that was momentarily at or near the gold export point; and (b) changes in money rates, which were usually upward when gold was flowing out and downward when gold was flowing in. The orthodox "rules of the game" implied that any automatic tendency for money rates to change in this way, according as gold moved out or in, was not to be neutralized, but was rather to be strengthened, by deliberate central bank action.

These changes in interest rates, besides directing the flow of liquid funds, tended also to speed up the process of change in national income and outlay in the countries concerned, a process which tended eventually to close the gap in the balance of payments. In the country losing gold, the rise in interest rates would put a damper on the initial expansion of demand, while in the gold-receiving country the interest reduction would stimulate the growth in national income arising initially from an increase in exports. These additional effects on national income and outlay depend, however, entirely on the degree to which investment expenditure is responsive to changes in interest rates. There is no way in which interest changes can affect national income, aggre-

gate demand, and eventually the general price-level, except through their influence on investment. This influence is sometimes fitful and uncertain; the volume of stocks of goods held, for example, is often governed more directly by price expectations than by interest charges, while investment in many types of fixed capital is closely dependent on the anticipated demand for the final product. From what we have said it is clear, however, that changes in interest rates, and their effects on investment, though they may be useful, are not an essential part of the adjustment process which closes the gap in the balance of payments. The shifts in aggregate demand, the investment decisions to which these shifts are likely to give rise and the accompanying cumulative changes in money income and expenditure may fully suffice to restore equilibrium.

Great emphasis was often placed in the past on the automatic adjustments in national cost- and price-levels resulting from the changes in interest rates under the gold standard mechanism. It is, however, only through their effects on investment and hence national income that changes in interest rates are capable of affecting the level of costs and prices. In the case of a reduction in interest, it is only through its stimulating effect on investment and business activity that a higher level of costs and prices may incidentally come about by reason of a keener competition for labour and other resources; in the case of a rise in interest, it is only through its depressing effect on investment, national income and employment that a fall in wages and prices may ensue. The changes in cost- and price-levels are a by-product of the changes in national income. As we have seen, the latter by themselves tend to operate in an equilibrating manner; for as total demand in a country falls or increases, so does the demand for imports.

It is true that this by-product in the form of a change in the cost- and price-level, in so far as it materializes, does introduce an additional equilibrating factor into the adjustment mechanism. A fall in a country's price-level will improve the competitive position of exports abroad and worsen the competitive position of imported goods at home; in this way a country will tend to secure for its exports a larger share of a given world demand and reduce the proportion in which its own demand is directed towards imports. These effects depend on the elasticity of demand with

respect to price and may or may not be sufficient to right the balance of payments. By contrast, the shifts in aggregate demand, of which the cost and price changes are a by-product, operate in the right direction independently of the price-elasticity of demand, and produce their equilibrating effects on the balance of payments more certainly and quickly. As costs, moreover, have tended to become more rigid in advanced industrial countries, the automatism of the price adjustment mechanism has been greatly reduced; and indeed, for the reasons indicated, it is a matter of doubt whether the gold standard was ever as effective in this connection as was formerly supposed.

But whatever the influence of interest rates may have been on the process of closing the gaps in balances of payments, a distinct and probably important function of interest changes in the gold standard mechanism was, as we have seen, to call forth equilibrating short-term capital movements so as temporarily to fill those gaps, the real adjustment taking place largely through the direct effects of changes in income and effective demand in the various countries. It is necessary to observe, however, that this mechanism of equilibrating short-term capital movements was confined, in the main, to countries with well-developed money markets: countries such as Great Britain, France, the Netherlands and Germany, at the end of the nineteenth century, with the notable addition of the United States later. Between these more developed financial and industrial centres on the one hand and the less developed agricultural and mining countries on the other, the propagation of cyclical movements as reflected in the balance of payments was dominated by two factors discussed earlier in this chapter, namely, the fluctuations in the demand for primary products and, largely in response to these, fluctuations in long-term foreign lending.

8. DISEQUILIBRATING MONEY FLOWS

The equilibrating type of short-term capital movement was possible only in a system in which there existed absolute confidence in the maintenance of fixed exchange parities among the currencies concerned. The gold standard prior to 1914 was such a system; it was a system in which exchange stability was accepted without question as the primary objective of monetary policy and in which there was a sufficient readiness to pursue this objective

even at the cost of internal instability. These conditions engendered confidence in exchange stability, and this confidence in exchange stability was essential if private liquid funds were to move in an equilibrating manner. If a banker was to be induced to transfer some of his liquid balances into a currency which stood temporarily at the gold export point, he had to be confident that the currency in question would not depreciate below that point; if the inducement consisted of interest differentials, then similarly he had to be confident that this slight gain would not be wiped out or turned into incalculable loss through exchange depreciation.

The confidence in exchange stability which existed before the war of 1914-18 was greatly weakened by that war and by the monetary disturbances immediately following. After the failure of the attempt to restore the pre-war system, confidence was still further undermined. In these circumstances, liquid funds failed to respond in the normal way to variations in exchange or interest rates; worse still, they responded increasingly in a disequilibrating manner. When, for example, the exchange depreciated or discount rates were raised, funds would often take fright and move out instead of inward. In consequence they often moved from countries with high to countries with low interest rates. Instead of taking some of the strain off the central gold and exchange reserves, they placed an additional and frequently unbearable strain on these reserves. They are aptly described as disequilibrating, especially as they usually proceeded from countries with a deficit to countries with a surplus in the balance of payments on account of trade and other normal transactions.¹

Such movements occurred several times on a large scale during the inter-war period. We may recall, for instance, the flight and repatriation of capital from and to France before and after 1926 respectively; the foreign participation in the United States stock market boom in 1928 and 1929; the sudden withdrawals of foreign short-term credits from Central and Eastern Europe in the early 'thirties; and above all, the mass movement of "hot money" to the United States in the later 'thirties, which, however, was largely due to the growing threat of war in Europe. Capital

¹ Cf. *International Currency Experience: Lessons of the Inter-War Period* (League of Nations, 1944. II. A. 4).

movements of this type do not represent basic investment decisions, and do not therefore necessarily increase employment, directly or even indirectly, in the country to which they flow.¹ In the countries from which they originate, however, they may well have serious effects on employment and incomes unless these countries institute exchange control, allow their currency to depreciate, or have enough gold to lose and are careful to offset the effect of this loss on the domestic credit base.

9. EFFECT OF TRADE RESTRICTIONS

It was noted above that a country experiencing revival and contributing to the spread of such revival abroad may not enjoy the subsequent increase in its exports needed to close the gap thus created, even though the prices of its exports are internationally competitive, if those exports are subject to special discrimination in foreign markets owing to tariff preferences, quotas, exchange restrictions, subsidies, cartel arrangements, etc. While some of these devices have long existed as special impediments to a free flow of international trade, their appearance as a major element in the structure of international economic relationships dates from the early 'thirties when they were introduced on a wide scale, usually as temporary expedients to relieve pressure on their balance of payments by countries faced with a crisis growing out of such a gap. Since then they have tended to persist and to be extended, partly because they have given rise to vested interests which have become dependent upon their continuance and, partly, because they have been useful in fostering economic mobilization during the war. The United Nations are pledged to attempt to remove them and to return to a freer trading system as conditions permit after the end of the war.

It is not the responsibility of the Delegation in this Report to analyze the merits or deficiencies of these various devices from

¹ The United States Department of Commerce has made the following comment on the flow of "hot money" to the United States in the 'thirties: "While internal activity did expand and a small excess of payments on current account did appear from 1925-7, the influx of foreign capital into the United States was apparently not an important factor in these changes. The capital was held largely in liquid form or employed in stock market transactions, and was not directly expended on a significant scale in new investments of an income-generating character" (*The United States in the World Economy*, U.S. Dept. of Commerce Economic Series No. 23, 1943, p. 192).

the point of view of their long-term effect upon the economic structure of the countries that employ them, but rather to concentrate upon their relation to the problem of international instability of business which is here under review. Once imbedded in the international economic structure, they raise the question whether any nation can afford to permit an internal revival to stimulate an expansion of imports when there exists the possibility that these special discriminatory devices may be employed to prevent the subsequent closing of the gap thus created. Clearly, if the probabilities are that such discrimination will be employed with sufficient effectiveness to prevent the closing of the gap, every country would be compelled to adopt similar devices in order to prevent its internal revival from stimulating its import requirements. Since all trade is mutual, and the import of one country is the export of another, this would tend to restrict international interchange on both capital and trade account to minimum levels. Such a general policy of restriction must result in a reduction in national incomes and a lowering of standards of living. For countries would no longer be able to purchase raw materials or foodstuffs or other goods where they can be produced with least effort and are consequently cheapest, but, as the restrictions gradually spread and became more rigorous, they would be forced back more and more on their own resources, resort to barter arrangements or be compelled to forego altogether what they cannot produce themselves. Stability would be purchased at the cost of poverty.

Section II.

Anti-depression Policies

CHAPTER VII

REGULATION OF TOTAL EXPENDITURE

1. THE IMPORTANCE OF THE GREAT INDUSTRIAL COUNTRIES

In the preceding chapters we have tried to describe the nature of economic depressions in the past, and the mechanism by which they were propagated and spread both nationally and internationally. The setting of our analysis has been the system of predominantly private enterprise economies which was universal in developed societies up to the last war and still prevails over the major part of the world. We have seen that such economies possess certain inherent tendencies to instability, tendencies which are closely bound up with the phenomena of economic progress and unevenness in the accumulation of capital. Apart from depressions in individual countries or areas caused by purely local and uncontrollable factors such as harvest failures, floods, etc., we found that the familiar type of depression, characterized by a more or less simultaneous fall in real income and output over a wide range of countries, seemed to result mainly from the wide fluctuations of investment and employment in industrial countries. A cumulative downswing, due to a decline in investment in one industrial country tended to spread to other countries through a decline in the demand for their exports. In primary-producing countries this was often the cause of a heavy fall in the price of their main products and consequently in the incomes of producers. The resultant decline in activity in these countries was reinforced by the cessation of capital inflow from abroad. The fall in the exports of other industrial countries resulting from the reduced purchasing power of the countries producing primary products often initiated a cumulative decline in spending and investment, which reinforced the tendency to world deflation. In a similar way a recovery of investment in any part of the system might set in motion an upward

cumulative tendency, the effect of which would also tend to be diffused over the whole area.

In both phases of the business cycle the rate of investment in advanced industrial countries was seen to play a vital role. As we stated in the first Part of our Report, "it must, we believe, lie with the great industrial markets of the world to adopt the constructive measures of major importance required to secure greater economic stability and to accelerate economic development".¹ We shall therefore turn our attention first mainly to the problem of securing greater stability of income and employment in industrial countries. But there are no clear lines of division either between major and minor industrial countries or between industrial and other countries, and many of the policies which we suggest in Chapters IX-XVII and in Chapter XX will be applicable to countries with a mixed economy and some even to states which are mainly dependent on agriculture. Chapters XVIII and XIX are devoted to a consideration of the policies appropriate for raw materials and food producing countries, whose stability is largely dependent on the demand of the industrial states for the products which they export. But here again no clear-cut division can be made; for of the great industrial countries the United States of America contributes largely to the world export of agricultural products, while the United Kingdom is as dependent on her export markets as many of the strictly agricultural states.

2. THE PROBLEM OF MAINTAINING AGGREGATE DEMAND

The general framework of the problem is essentially a simple one. In any country, the level of employment depends immediately on the amount of expenditure. If insufficient is spent to buy the whole output of the gainfully occupied persons of that country some people will be unemployed. The special difficulty of maintaining effective demand in advanced industrial countries arises from the relatively great importance in the whole economy of the saving-investment process. If everyone spent the whole of his earnings on consumption goods, there would be less tendency to cumulative unemployment, but at the same time there would be less capital formation and less economic progress. In an economy where people save part of their incomes either for future con-

¹ *The Transition from War to Peace Economy*, League of Nations, p. 16.

tingencies or to add to their wealth, the maintenance of employment depends on an equivalent amount of expenditure being directed to investment. As we saw in earlier chapters, depressions arise in advanced industrial countries mainly as a result of the fact that changes in investment plans do not always synchronize with changes in decisions to save. Owing to this lack of synchronization a constant watch must be kept on the current and prospective movement of each class of expenditure, if a stable rate of spending is to be secured. The price of stability is "eternal vigilance".

To say that employment in any country depends on spending in that country is, however, an over-simplification in that it assumes complete mobility of productive resources. To consider labour as a whole irrespective of its skills, or plant as a whole irrespective of the purpose for which it was designed, is misleading. It is equally misleading to assume that a country resembles a currentless ocean on which the labour force can and will move untrammelled by home ties or uninfluenced by costs of transport or the unknown risks of new ventures. If unemployment were concentrated in California, for instance, the level of employment in the United States would not be determined by the amount of spending in the country as a whole, but would differ according to whether the spending took place in California or elsewhere. Because labour is not perfectly mobile, a given amount of spending will create more employment if directed to areas and industries where there are unused resources than if directed to parts of the economy where resources are already fully utilized. We shall return to this important problem in Chapter XV.

The amount that must be spent in any area to secure a given level of employment depends mainly on four factors:

- 1) the number of persons seeking employment;
- 2) the amount of work to be provided per person (depending on hours of work, holidays, etc.);
- 3) the average physical productivity per man-hour; and
- 4) the prevailing and expected wage and price levels.

Perhaps we may illustrate the problem most clearly by means of a rough estimate of the United States Department of Commerce

of the amount of spending necessary to maintain "full employment" in the United States in 1946.¹

The gross national product² of the United States in 1940 was \$97 thousand million. The natural increase in the labour force is at present at the rate of about 1 per cent per annum. Allowing for a trend towards longer schooling and earlier retirement, assuming that most of the women and other war workers not employed before the war will not be seeking employment after the war, and allowing for almost 2 million in the armed forces as against less than half a million before the war, it is estimated that the civilian labour force in 1946 would be 2½ million higher than in 1940. Account is further taken of the fact that in 1940 8.9 million were unemployed. Allowing 2 million as a practical minimum to which seasonal, frictional and localized unemployment might be reduced,³ the Department of Commerce comes to the conclusion that a general "full employment" policy would have to provide jobs for nearly 10 million more persons in 1946 than in 1940.

In the meantime, physical productivity is continually increasing as a result of technological developments, capital accumulation and shifts from less to more productive jobs. Over the 12 years 1929-41, the national output per man-hour of employment in the United States increased by 34 per cent, that is, at the rate of 2½ per cent per annum. About the same rate prevailed in the previous 30 years, and the rate is likely to have been accelerated rather than retarded during the war.

Combining the increase in manpower and productivity, and assuming hours of work to revert to the 1940 level (average 38.1 per week in manufacturing and 40.7 per week in non-manufacturing industry), the potential physical output in 1946 would be 46 per cent higher than that of 1940. The dollar value of that output

¹ *Senate Document, No. 40, 78th Congress, First Session: "Markets after the War"*, prepared under the direction of United States Bureau of Foreign and Domestic Commerce of the Department of Commerce, Washington, 1943. Cf. also "Post-War Manpower, and its Capacity to Produce" (*Survey of Current Business*, April 1943).

² Gross national product is defined as the total cost of goods and services to the ultimate consumer, including producers' capital goods and government services.

³ Unemployment fell temporarily to about this level in 1929 and has fallen much further during this war. It would, however, be unreasonable to expect unemployment to persist at the present low level (less than 1 million) in the absence of special wartime pressure and regulations.

would depend on the prevailing price level. Allowing only for such increase in prices as took place between 1940 and 1942, the Department of Commerce estimated that the capacity gross income of the United States in 1946 would be \$165 thousand millions. If the further price rise since 1942 is taken into account, the capacity output of 1946 (at present prices) would be about \$175 thousand millions.

The above calculation is summarized simply to illustrate the general nature of the problem: the need for increased national spending to match increased capacity to produce, if the level of employment is to be maintained. As already mentioned, the actual relationship between spending and employment will depend largely on the mobility of resources and on whether the spending is directed towards areas where unused resources are available. In the immediate post-war period there are, in fact, likely to be serious maladjustments and large local pockets of unemployment, so that the question of mobility and wise direction of spending will be of particular importance. But the main point to be brought out is that at recent rates of increase, population and productivity in the United States are likely to add 3 per cent or about \$5 thousand million at current prices to the national capacity gross output each year. Granted there is no radical fall in prices, then if spending does not expand at that rate, the increased capacity to produce will "go to waste" in rising unemployment.

The rate of growth is likely to be substantially less in other advanced industrial countries where the natural increase in the labour force is slower, the scope for and trend toward shorter hours, longer schooling or earlier retirement greater, and the rise in productivity less rapid, and in most of which, moreover, great war damage has been suffered. But in all countries the general problem is the same: unless sufficient is spent to buy the total output at "full employment", unemployment will result.

3. POSSIBLE LINES OF POLICY

The actual spending which determines the level of employment in any country is of various kinds. The major part consists of spending by private individuals on consumption goods and services. Another part consists of private investment expenditure on new business equipment, buildings, and additions to stocks as well

as replacement of worn-out plant and equipment; a third part consists of expenditure by public bodies—either local or central governments or other public agencies—and this expenditure, like that of private individuals, may be either on current (immediately consumable) or on capital goods. Finally, employment in a given country can be created by the expenditure of foreigners either in the form of purchase of that country's goods and services or of investment expenditure by foreigners using local resources in that country. Against this expenditure of foreigners must, however, be set the expenditure of the nationals of the country in question on imports or capital outlay using foreign resources which serves to create employment in other countries but not at home. It is only the net excess of foreign expenditure in the country over domestic expenditure abroad which constitutes a net contribution to employment-creating expenditure in that country itself.

The relationship between expenditure, output, and incomes may be summarized as follows:

I	II	III
<i>National Expenditure</i>	<i>National Output</i>	<i>National Income</i>
Personal expenditure on consumption goods and services	Value added by	Rents
Private investment expenditure (in fixed plant, buildings, equipment and stocks)	Agriculture	
Public expenditure on current goods and services	Mining	
Public investment expenditure	Manufacturing	Profits and Interest
Net foreign investment	Transport	
	Distribution	
	Personal Services	Salaries
	Value of Government services	
	Net income from abroad	Wages

If the items in each column are appropriately defined, the three columns add up to the same total; in other words, national expenditure, output and income are simply different aspects of the same thing.

The main object of employment policy may be described as that of regulating the various constituents of national expenditure in such a way that they add up to the value of what we have called "gross capacity output".

This statement of the problem, however over-simplified, serves to present the framework within which the problems of maintain-

ing a high and stable level of employment that actually arise must be attacked. We must not forget, however, that even the framework is subject to alteration. The determination of physical capacity output is itself dependent on prevailing hours and conditions of work; while the value of this capacity output is dependent on vital questions of price and wage policy which must also be considered as part of the problem of securing a high level of employment. Moreover, once the framework is set, there begin the practical problems of deciding which elements of national expenditure should be influenced, and where and how.

Statesmen are, after all, interested not only in securing a high and stable level of employment. What is required is that resources be employed as productively as possible. There is no sense in merely "digging holes" in the ground to prevent unemployment. Serious malnutrition due to insufficient incomes is prevalent in all countries,¹ and provision for less urgent needs than food is still more inadequate. Even in a country with such a relatively high standard of living as the United States, in 1940 "a large number of people went without such things as sheets and shoes, which would generally be recognized as necessities".² We must aim at the maximum output of goods and services, and therefore the promotion of technical progress and efficiency must be a central part of policy.

In view of the immobility of resources to which we have already referred, it is also important to consider where spending should be influenced. This problem will be dealt with further in Chapter XV; but we should like to draw attention at this point to its implications in regard to inflation. Generally, the problem of avoiding inflation is the exact converse of that of avoiding unemployment. If insufficient is spent to buy all the goods and services that can be produced with available productive resources, unemployment will ensue; if too much is spent, the result is inflation: prices rise but output cannot expand. The same situation may arise in the course of recovery if the volume of spending, while not excessive as a whole, is misdirected. If so much is spent in certain areas or on certain goods that production cannot be increased to satisfy the demand at existing prices, prices will rise, while unem-

¹ Cf. *Final Report of the Mixed Committee on Nutrition* (League of Nations, London, 1937).

² *Senate Document No. 40* (U.S.A.), p. 4.

ployment in other areas or in other industries is unaffected. A misdirection of spending thus implies a failure in both directions simultaneously—a failure to reach full employment on the one hand, and a failure to avoid inflation on the other.

Governments may influence both the total volume of expenditure and its direction by their own disbursements and by measures designed to stimulate one form or another of private demand. We shall examine these two alternatives in subsequent chapters and will confine ourselves here to observing that the exercise of such influence constitutes for governments the essence of the task of preventing depressions.

There should be no misunderstanding about the immense complexity and difficulty of this task. But if, as we believe to be the case, governments are prepared to treat the maintenance of a high and stable level of employment as a prime object of policy, many of the difficulties which may have seemed almost insuperable in the past will assume very different proportions.

The maintenance of a high and stable level of employment implies that public revenue and expenditure are no longer looked upon as end products but as part of the whole mosaic of national income and national expenditure. It implies that the whole machinery of government is adapted to the execution of the two possible lines of policy we have just mentioned. It implies in particular that budget authorities should add to the function of scrutinizing individual items of government expenditure that of determining and helping to maintain the total volume of national expenditure. The execution of this new function will necessitate the collection and analysis of information on a wider scale than has hitherto been regarded as necessary for the formulation of public fiscal policies (more especially information relating to national income and balances of payments). It will necessitate also—what may prove more difficult—a break with the traditional psychological attitude towards fiscal problems. For a purely financial will have to be substituted a broadly economic approach to the budget.

The exigencies of war have forced the budget authorities of many countries to make this shift in approach. In particular we may mention the analyses of the national income contained in the various White Papers issued by the United Kingdom Treasury in connection with the annual budgets of the past few years. We

strongly urge that all governments develop the statistical information and evolve the administrative machinery necessary to enable them to approach the problem of public finances from a broad economic point of view.

CHAPTER VIII

CONSTITUENTS OF NATIONAL EXPENDITURE

1. THE CONSTITUENT PARTS

We showed in the preceding chapter the relationship between national expenditure, national output and national income. It is necessary to consider now in a little more detail the constituent parts of the national expenditure and their influence on national output and on employment. Let us consider first what role was played by different elements in the national expenditure in two highly industrialized countries before the war. The following table gives the approximate expenditure on private consumption and home investment, public expenditure on goods and services, and foreign investment in the United Kingdom in 1938. Unfortunately, it is not possible to isolate satisfactorily that part of investment expenditure which was under public control.

TABLE IX

United Kingdom Gross and Net National Expenditure in 1938¹

	£(000,000's)	Per Cent
1. Personal Consumption Expenditure ²	4,138	75
2. Net private investment at home ³	305	5
3. Public expenditure on goods and services ⁴	837	15
4. Net foreign investment (public and private)	— 55	— 1
5. <i>Net National Expenditure</i>	5,225	94
6. Capital replacement ⁵	340	6
7. <i>Gross National Expenditure</i>	5,565	100

¹ Cmd. 6520: *An Analysis of the Sources of War Finance and Estimates of the National Income and Expenditure in the Years 1938 to 1943* (London, April 1944). The figures used are those based on market prices.

² This figure includes £66,000,000 on account of services in connection with acquisition and transfer of property, etc.

³ This figure includes a certain amount of investment by public bodies such as the capital expenditure by the Post Office, of the housing or trading services of local authorities, or of publicly owned corporations.

⁴ This figure includes local as well as central government expenditure, but excludes public transfer expenditure (pensions, debt, interest, etc.). Separate data on the capital expenditure (roads, schools, office buildings, etc.), included in this total are not available.

⁵ This item does not include that part of public capital replacement expenditure that falls under item 3.

More detailed information covering a number of years is available for the United States, which makes it possible to show how the importance of the different factors varies with the level of national income.

TABLE X

United States Gross National Expenditure at Current Prices¹

\$(000,000,000's)

Home:

<i>Private:</i>	1929		1932		1938	
Personal Consumption:	\$	%	\$	%	\$	%
Durable goods	9.9	9.4	3.8	6.4	5.4	6.3
Semi-durable and perishable goods	40.9	38.7	24.9	42.0	34.5	40.4
Services	27.2	25.7	19.7	33.2	22.3	26.1
Total	78.0	73.8	48.4	81.6	62.2	72.8
Gross investment:						
Residential construction	3.0	2.8	0.4	0.7	1.7	2.0
Business construction	4.6	4.3	1.1	1.9	2.0	2.3
Producers' durable goods	6.9	6.5	2.0	3.4	5.2	6.1
Changes in stocks	2.4	2.3	-2.4	-4.0	-0.3	-0.3
Total	16.9	15.9	1.1	2.0	8.6	10.1
<i>Public:</i>						
Government expenditure for goods and services:						
Federal (including defence)	2.0	1.9	1.8	3.0	5.9	6.9
State and local	8.3	7.8	7.8	13.1	7.6	8.9
(Public construction)	(2.9)	(2.7)	(1.9)	(3.2)	(3.5)	(4.0)
Total	10.3	9.7	9.6	16.1	13.5	15.8
Foreign:						
Net expenditure on investment abroad and gold and silver imported	0.6	0.6	0.2	0.3	1.1	1.3
Gross National Expenditure	105.8	100	59.3	100	85.4	100
(Depreciation and depletion charges, contingency reserves, etc.)	(7.8)	(7.4)	(7.7)	(13.0)	(6.7)	(7.8)

¹ Estimates of consumers' expenditure on durable, semi-durable and perishable goods, residential and business construction, producers' durable goods and changes in stocks are from S. Kuznets' *Commodity Flow and Capital Formation* and supplementary Bulletin No. 74 of the National Bureau of Economic Research (New York, 1938 and 1939, respectively). Estimates of expenditure on services rendered directly to consumers are from Appendix A, Table 22, of Harold Barger, *Outlay and Income in the United States, 1921-1938*.

Federal Expenditure on Goods and Services was obtained by subtracting from federal expenditure as reported in Daily Treasury Statement, those transactions not involving purchase of goods and services (loans, pensions, debt interest, pur-

By far the major part of national expenditure in both countries consisted of private expenditure on consumption goods and services. This proportion was highest in the depression, but even in the 1929 boom in the United States, it amounted to about three-quarters of gross national expenditure. Within the field of private consumption expenditure the importance of durable goods ranged from about 8 per cent in 1932 to 13 per cent in 1929 (corresponding to 6.4 per cent and 9.4 per cent, respectively, of all expenditure, as shown in the table).

Private gross investment, though never constituting more than a relatively small proportion of total expenditure, played a disproportionately important role owing to its high variability. Furthermore, its fluctuations give rise, by means of the cumulative processes described in Section I, to much greater absolute variations in the national expenditure as a whole.¹

A somewhat similar distribution of expenditure would, no doubt, be found in other industrial countries with free enterprise. The proportions are of course entirely different in the totalitarian countries, and also in all belligerent countries today where public expenditure has become the dominant factor in the national expenditure as a whole.

Total national expenditure may fall on account of a drop in any item of the above table and rise again on account of any item. Moreover, owing to the inter-relationships already described, changes in one section of the economy are likely to spread to other parts. An increase in public expenditure or private investment, through its effects in increasing incomes, may generally be expected to lead directly to an increase in consumption expenditure. Similarly, an initial increase in consumption expenditure will not only tend to spread in the consumption field *via* the increase in incomes, but is likely also to induce additional expenditure on capital goods and the replenishment of stocks.

chase of existing assets and grants to States and local governments). State and local expenditures were measured by receipts plus net changes in debt (*cf.* R. Stone, *The National Income, Output and Expenditure of the United States of America, 1929-41*, in *Economic Journal*, London, June-September, 1942, pp. 154 *et seq.*). Estimate of public construction is from S. Kuznets, *op. cit.* Net change in foreign claims based on estimates of Hal Lary, U.S. Bureau of Foreign and Domestic Commerce, quoted by R. Stone (*op. cit.*).

¹ *Cf.* Chapters III and IV.

2. WHERE SHOULD REVIVAL BE STARTED?

Should we conclude, in view of the inter-related nature of the whole system, that it is a matter of indifference to what point in the economy measures to revive business are first directed or from what point revival naturally springs?

It is frequently argued that the "natural" cure for unemployment is a stimulation of investment. The main reason given is that since depressions seem to arise from the instability of private investment, anti-depression policy should be directed principally to stabilizing this type of expenditure.

A further argument often brought forward is that expenditure on capital goods is likely to have a better balanced and more widespread effect than an equally large expenditure on consumption goods. Workers engaged in the manufacture of capital goods as well as those engaged in the production of consumption goods will spend their wages on consumption goods, thus stimulating the consumption goods industries. But investment goods industries are unlikely to be stimulated immediately in times of depression by increased expenditure on consumption goods, as there will probably be a considerable number of machines lying idle. It follows that if the initial expenditure is on consumption, it is very uncertain how soon and to what extent capital goods industries will be stimulated. If, on the other hand, the initial expenditure is on investment, we can be sure that not only capital goods industries but also consumption goods industries will be stimulated.

On the other hand, just because machines are likely to be lying idle it may prove in practice difficult to find branches of industry in which investment can be profitably stimulated for the home market. There might well prove to be less difficulty in the case of public investment on, for instance, roads, schools, parks, etc., that render services which are not sold to the market and do not require additional effective demand to make them "pay". Such public expenditure would require to be carefully planned in such a manner as to render it possible to taper it off as economic activity in general recovers. But the type of labour employed on investment of this kind may be entirely different from that employed in the private investment industries whose fluctuations it is desired to counteract. Most of the above difficulties may be avoided if indus-

tries producing capital goods are stimulated by foreign orders. But foreign orders may not be available, and in these circumstances it may be preferable to endeavour to stimulate consumption expenditure directly, rather than through domestic investment.

It should be clear from the above discussion that there is no single logically or economically correct way of approaching the problem of maintaining a high level of employment. The choice of the area of spending is a problem of economic analysis on each occasion and of social policy. The circumstances which present themselves on the occasion of each recession in business must determine in practice the measures actually adopted. We deal in subsequent chapters with some of these varying circumstances and with what seem to us to be appropriate measures to meet them. But the general line of policy along which those measures are likely to lie will depend on what the community prefers to do when "spare" resources occur. Does it wish to attempt to increase current consumption? If so, whose consumption, and the consumption of what? Or does it prefer to attempt to increase its own productive equipment or foreign investment so that consumption can be increased later on? There is ample scope for advancement in all directions, even in the richest and most highly industrialized countries. The choice is likely to differ in communities at different stages of development—those which are industrially under-developed will naturally give a higher priority to the accumulation of domestic capital equipment, while the older and industrially advanced countries can afford and may prefer a more direct increase in domestic living standards, or investment abroad. But there should be general agreement on one fact: the "spare" resources should not be allowed to go to waste.

3. THE SPECIAL PROBLEM OF STRUCTURAL UNEMPLOYMENT

We have been discussing so far the choice of methods for counteracting cyclical depressions—general deficiencies in expenditure originating mainly in periodic recessions in private investment. The central consideration in such situations is to prevent the fluctuations in private investment from taking place, or, failing that, to ensure employment elsewhere for the resources periodically released in this way. But we must not overlook deficiencies in ex-

penditure, and depressions which arise from structural causes, as in such cases the considerations determining the choice of the area of spending are likely to be different.

When there is a shift in demand, resources become unemployed in certain industries and the recession may not be a temporary one. If demand is shifting away from the depressed industries towards other industries, causing local structural prosperity in the latter, a stimulus to expenditure in the structurally depressed industry is not an appropriate remedy, and an attempt must be made to expedite the shift of unemployed resources to the more prosperous industries. In such a case the problem is not so much one of increasing expenditure of any particular category as of adapting the national resources to the change in demand. This sort of problem will be extremely prevalent during the transition period after the war, and was discussed at some length in the first Part of our Report.¹ The general question of policies to be adopted in the case of localized unemployment is dealt with more fully in Chapter XV. The possibility that unemployment arising out of a long-run tendency in "mature" economies for savings to run ahead of investment opportunities may become chronic will be discussed in Chapter XVI.

In discussing the selection of the most appropriate elements of expenditure to be influenced for the purpose of securing a high and stable level of employment, we have confined ourselves in the present chapter mainly to domestic expenditure. The further possibility of increasing employment through the foreign balance introduces additional complications owing to its simultaneous and opposite effects on the foreign balance of other countries. This question will be dealt with further in Chapters XIII and XVII.

¹ *The Transition from War to Peace Economy*, League of Nations, Chapters I and II.

CHAPTER IX

PRIVATE CONSUMPTION EXPENDITURE

1. THE IMPORTANCE OF EXPENDITURE ON NON-DURABLE GOODS

Expenditure by private individuals' on non-durable consumption goods and services constitutes by far the largest part of national income in peacetime. Though stable relatively to investment expenditure, consumption is nevertheless subject to fluctuations which are absolutely large—fluctuations which are a direct result of the changes in the level and distribution of income associated with the investment cycle.

2. SOCIAL INSURANCE

Our first concern must be to prevent these secondary effects on consumption of cyclical fluctuations in investment. One of the main reasons why consumption falls as a result of a decline in investment is because of the reduced expenditure of those who become unemployed and of their families. A system of unemployment insurance will, therefore, contribute to the stability of consumers' demand. By such an insurance system the connection between production and income in periods of depression is rendered looser. A limit is set beyond which incomes cannot decline and this fact helps to sustain demand both directly and for psychological reasons. Without the sense of security created by unemployment insurance, even workers in employment are reluctant to maintain their customary level of purchases in times of depression.

The administration of unemployment insurance reserve funds will—if combined with the appropriate monetary policy¹—provide a mechanism for helping to even out the general flow of purchasing power. If the premium payments are so calculated that they cover unemployment benefits in times of average unemployment, a surplus will automatically be achieved when unemployment is less than normal, that is, in years of exceptionally good trade, and a deficit incurred when unemployment is greater than normal, that is, in periods of bad trade. The fund should be so administered that it does not result in an increase in the demand for goods when unemployment is low. The total demand will thus tend to be stabil-

¹ See page 167.

ized, and the postponement of the effective spending from this fund till general activity slackens will help to sustain total demand when the ordinary sources of the flow of purchasing power are drying up. Moreover, in the conditions postulated, the contribution to the maintenance of total purchasing power in periods of depression is made without any increase in state borrowing or spending. But it is important that the system of unemployment insurance should be so organized that its rates and conditions of benefits do not unduly reduce the mobility of labour or interfere with necessary structural adjustments, and that it should be combined with positive measures to promote mobility.

Other types of social incomes such as old age pensions, family allowances, etc., which are received irrespective of the state of business activity, also have a stabilizing influence on the level of consumption. The value of family allowances in helping to provide for adequate nutrition, housing, clothing and other essential needs of the rising generation is becoming increasingly widely recognized. The assurance of an adequate and stable level of consumption on the part of the more vulnerable sections of the population—families with children and old people—would help to put a bottom to the volume of consumption as a whole, which would materially reduce the amplitude of fluctuations resulting from variations in investment.

3. STABLE WAGE RATES

The question whether rigidity of wage rates themselves is a stabilizing influence is one on which opinions differ. Apart from the social and political issues involved, this is due chiefly to the fact that wages constitute both an element of income and an element of cost. The wage problem thus has two aspects, and discussion has often tended to concentrate on one aspect to the neglect of the other. The result has been that for one and the same purpose—namely, that of promoting recovery from depression—diametrically opposed measures have frequently been proposed: some have urged a general increase in wage rates, while others have advocated a general reduction. There is an element of truth in each of these views; but both are essentially partial and one-sided in their appraisal of economic interrelationships; and both are therefore misleading guides for action.

The first school maintains that a general increase in wage rates when business slackens would raise the aggregate purchasing power of wage earners and hence stimulate demand for consumable products. This is quite possible, provided the volume of employment remains unchanged, or at least falls less than in proportion to the rise in wage rates. But this is unlikely to happen. Entrepreneurs, seeing their wage costs go up, are likely to decide to curtail production immediately, and their total wage bill may easily become smaller than before.

The other school argues that a general reduction in wage rates in such circumstances would tend to restore the profit margin and consequently encourage entrepreneurs to expand production and capital outlay. This, again, is quite conceivable—provided aggregate demand and the level of prices remains unchanged or at any rate does not fall by the same amount as wage costs. But if prices fall *pari passu* with wages, then the profit margin is not enlarged and no stimulus is given to productive expenditure. In the form in which it is usually presented, the argument in favour of wage reduction is valid in the case of an individual firm or industry. Its application to the whole economy is an example of a common fallacy in economic thinking. The price-cost structure must be such as to permit business to work at a profit; but in the case of a general reduction in wage rates, it is not legitimate to assume that demand remains constant. Under favourable conditions, the fall in demand may be less than the reduction in wage income; and in this case some net improvement in activity may ensue. But if the wage reduction should lead to an equivalent decline in consumers' demand, there would be no reason to expect any increase in the volume of output and employment; on the contrary, the general depressing effects of falling prices would prevent recovery.

We believe that it would be unwise to attempt either a general increase or a uniform reduction of wage rates during a depression, but that the whole wage structure should not be frozen, and changes in individual rates which give promise of increasing total wage payments should be encouraged. Our broad conclusion, therefore, is that whatever changes may be made in individual wage rates the total wage bill, aggregate labour income, should as far as possible be kept stable in a depression. A general wage increase

would raise costs without necessarily increasing purchasing power and a general wage decrease would reduce aggregate purchasing power and therefore intensify, at least for a while, the deflationary spiral. A qualification to this statement, which is necessary when the international trade position of a country is taken into consideration, will be discussed later. If what is looked for from a reduction in wages is an increase in liquidity this can be attained more quickly, painlessly and smoothly by the monetary and fiscal policies discussed throughout this Report.

This conclusion does not mean that we rule out a downward adjustment in the total wage bill in a particular industry if that reduction is a necessary corollary of a general programme for reorganization or modernization of the industry. We are interested in stabilizing the aggregate labour income as a whole rather than any particular part of it. Nor should it be interpreted to mean that particular wage rates which are out of line should never be reduced. Care should be taken, however, that such wage reductions as are effected do not lead to a general contraction in payrolls and purchasing power. This would not occur if wage cuts are confined to those industries in which there is a good chance that employment will rise or a decline in employment can be prevented by a reduction in wage costs. If that is done, the wage bill will not be lowered below what it would otherwise have been, and the aggregate purchasing power of wage earners will be increased or at least not be reduced by the fall in wage rates. Occasionally agreements have been made between employers and unions to the effect that unions accept wage reductions provided employers undertake to increase employment or to refrain from cuts in output and employment which they otherwise would be forced to make. Granted a real prospect of increasing or maintaining employment, such agreements should be encouraged. Apart from this it may be observed that the deflationary danger of these wage reductions will be removed if the policy of selective wage adjustments is not pursued in isolation, but is combined with a general policy of expansion which utilizes the monetary, fiscal and other measures proposed elsewhere in the present Report.

However, our conclusion that a general wage cut would intensify domestic deflation is not necessarily true in the case of a

single, comparatively small country which might be able without fear of retaliation, to stimulate exports and restrict imports by reducing wage and other costs. But this change in the trade balance of one particular country is equivalent to an opposite change in the trade balance of the rest of the world; and it is possible, therefore, that the expansion of business activity in that country might take place at the expense of other countries. If the policy is adopted simultaneously by a large number of countries, it would obviously defeat its purpose. The case is broadly analogous to currency depreciation, with which we deal in a later chapter. A single country may be able to stimulate its economic activity by lowering its exchange. But competitive currency depreciation, if universally resorted to, can bring no ultimate gain to any country; and the same would be approximately true of competitive wage-cutting on an international scale.

The position is of course different if a country adopting a policy of wage reduction introduces at the same time an expansionist policy which stimulates imports as much as the wage cut stimulates exports. In that case no net unfavourable effect need be imparted to the rest of the world.

4. FARM INCOME

The conclusions with reference both to the wage bill and to wage rates apply both to industrial and to agricultural wages. But in many countries farm wages only constitute a minor portion of total agricultural income, as the peasant or the farmer employs little hired labour. We consider the problem of the money income of this class of worker in Chapters XVIII and XIX and, although those chapters are mainly devoted to countries whose exports consist largely of raw materials and foodstuffs, much of the discussion contained in it applies also to farmers in industrial states. We should perhaps anticipate that discussion as regards one point here. Industrial countries may find the level of their farm income threatened by wide fluctuations in the world prices of foodstuffs or raw materials, and, especially when their imports of these products are small, may be tempted to obviate this threat by imposing quantitative control over imports. We are not of the opinion that the imposition of such national controls constitutes the appropriate solution of this difficulty. The right solution is to be sought in

the various international measures which we suggest in Chapters XIX and XX.

5. EQUALIZATION OF INCOME

The fact that consumers' expenditure is more stable than investment implies that countries in which a large proportion of expenditure is devoted to consumption (especially of non-durable) goods are likely to be more stable than those in which that proportion is smaller. If this is not universally true, that is, as we have shown in Chapter IV, due to the fact that some countries with small investment expenditure are dependent upon the demand of highly industrialized states for the sale of important export products. But apart from the effects of such dependence a high consumption economy is likely to be more stable than a high investment economy.

Measures adopted to render income more equal are for these reasons likely to make the economy more stable and, by broadening the mass market for commodities, increase opportunities for investment. On the other hand, if greater equality in the distribution of income results in a lower level of investment, it will check progress and the rate at which national income and standards of living can be raised. Poorer countries are likely to attach more importance to rapid progress and less to stability, and rightly so, for first they are less liable to instability on account of their investment industries, and secondly, the instability to which they are liable, when derived from abroad as it generally is, can scarcely be lessened by income redistribution. The structural problem of income distribution in connection with depressions presents itself therefore as a practical issue, mainly in the richer industrial states.

The manner in which greater equality in the distribution of income is brought about will determine in part its influence on economic progress. There are two possible means: the one is to increase the productivity or the purchasing power of the lower income groups, while affecting as little as possible the purchasing power of other groups; the other is to transfer purchasing power from the richer to the poorer sections of the population. The first method should add both to stability and to progress; the second method, if it involves very high rates of taxation, may check progress. All measures for improving economic opportunity, public

health, housing conditions, educational facilities, etc., will promote the productivity of the lower income groups but higher old age pensions, for instance, will not do so. Measures which do increase the productivity of these groups will, granted unemployment is avoided, raise their standards of living and their share in the national income. Their share in the national income may similarly be increased by reducing the prices of goods of primary necessity, foodstuffs, clothing, etc., whether by lowering tariffs or by improving the organization of production and distribution. Measures such as these to increase productivity or the purchasing power of the lower income groups do not necessarily involve any transfer of purchasing power though they are likely to do so. Whether they do or not depends on the one hand on the fiscal system and on the other hand on the extent to which all share in the greater prosperity to which they give rise. When the alternative policy is adopted alone and purchasing power is deliberately transferred from the higher to the lower income groups without consideration of its effect on the productivity of the lower income groups, the beneficial effects of this transfer through promoting stability may still outweigh any check to progress which it causes owing to high rates of taxation.

In all countries in which the general fiscal structure is such that the incidence of taxation as a whole is progressive, and especially where there is advanced social legislation, governments do in fact effect a greater equality in the distribution of income by fiscal means even though this may not be their primary motive. The extent to which such means can be wisely adopted for affecting the ratio of consumption to investment must depend upon the particular conditions obtaining in each country.

6. DISTRIBUTION OF SAVINGS

There will be a maximum assurance of stability of demand when the distribution, not only of income, but of capital is more widespread than is characteristic of most modern industrial economies; for in such circumstances the demand of the great mass of the population will be kept up to some extent by drawing on its reserves of savings. The small investor normally places his savings in fixed interest-bearing securities, insurances or in savings banks, and will, therefore, not be affected by the drop in profits when

business activity declines. To secure a wider distribution of capital a number of measures, positive or negative, are required. First, it is necessary to promote saving by affording suitable facilities for the small investor; secondly, it is necessary to avoid inflation. In one country after another in recent decades the small investor has lost all or a large part of his savings through radical changes in the purchasing power of money. Inflation inevitably tends to render the distribution of capital more uneven in any society in which there are many small creditors.

7. DURABLE CONSUMERS' GOODS

We saw¹ that the fluctuations in demand for consumers' durable goods were closely related to their prices and to the level and distribution of consumers' incomes. As in the case of producers' durable goods, changes in the demand for consumers' durable goods depend upon the rate of income increase or changes in income distribution or in taste. If the rate of growth of national income falls, a slump in the market for durable goods is likely to occur. A slump may also occur for other reasons. During a period of stock exchange activity individuals may anticipate their profits which may not be realized; or, owing to some political event, confidence may be adversely affected, a liquidity crisis may be started, and buying of durable goods be postponed by the public. The effects of political events may prove difficult to counteract rapidly; but it is in the interest both of the producers of these durable goods and of the national economy as a whole that any tendency to excessive expansion should be checked at the outset. This can be most effectively accomplished by varying the terms on which consumers' credit is granted. Indeed so considerable a proportion of the total sales of durable goods is effected in many countries on credit that this constitutes one of the most important instruments available today for promoting stability in this market. It should be observed, however, that changes in interest rates are not a very effectual method of control as, owing to the relatively short duration of consumer instalment credit, such changes only exercise a slight influence on the size of the monthly or weekly instalments. It is by changes in other conditions of lending, namely the down payment percentage and the length of the amortization period, that the

¹ Chapter IV.

volume of credit and of purchases can be most effectively influenced.¹ By reducing the down payment and increasing the amortization period during depressions the monthly charge on income can be substantially reduced and sales thereby promoted. Similarly, sales could be curtailed during booms by the reverse policy. It is important, therefore, that instalment credit policy should be co-ordinated and integrated into the general credit policy of the monetary authorities of each country; otherwise a single financing company stiffening its terms in order to prevent over-expansion would merely lose business to other companies.

Manufacturers of durable consumers' goods might themselves contribute towards stability of output by lowering prices when demand wanes and in some cases by producing for stock during periods when consumers' demand falls off. Production for stock, which would have the advantage of taking place when costs were relatively low, would need to be facilitated and encouraged by credit policy. In the case of automobiles there are, however, rather serious difficulties. Apart from the physical difficulty of storing automobiles in the numbers required to keep production relatively stable, a difficulty which presents itself in the case of many durable goods, the automobile industry in almost every country introduces annual changes of style, and manufacturers would lose part of their market if these changes—as well as technical improvements—were not made regularly. Stocks of old models in the hands of producers would have to be sold at reduced prices once the new models were introduced. These difficulties apply with less force to parts. In the case of furniture and household appliances, changes in style are less frequent and manufacture for stock therefore more feasible.

One further possibility of helping to stabilize the demand for furniture and household equipment appears worth considering. Almost every government subsidizes the provision of housing for low income groups. Frequently, families moving to new houses built with state assistance are poorly equipped with furniture. The possibility of extending assistance (through direct subsidies, or provision of specially favourable credit terms) for the acquisi-

¹ Cf. G. Haberler, *Consumer Instalment Credit and Economic Fluctuations* (published by National Bureau of Economic Research, New York, 1942), Chapter 6.

tion of furniture and household equipment for subsidized dwellings might be explored by the competent authorities. Such a policy has in fact been carried out, we understand, successfully by one government, and has been approved by the British Government as a special post-war measure.

CHAPTER X

PRIVATE INVESTMENT

1. THE IMPORTANCE AND NATURE OF PRIVATE INVESTMENT

We have seen that irregularity in the flow of private investment is the main cause of instability of national income in industrially developed countries. The volume of private investment fluctuates more widely between periods of prosperity and depression than any other part of the national income. In so doing it generates changes in total income leading to fluctuations in expenditure on consumption goods and services.

Clearly the first aim should be to reduce the fluctuations in private investment themselves, since this would promote security of employment in the same job. In the present chapter we shall confine ourselves to possible policies for reducing such fluctuations, treating separately construction, investment in producers' plant and equipment and investment in stocks of commodities.

Before turning to a consideration of the different classes of private capital expenditure, however, there are certain observations of a general order that we desire to make. To the extent to which the state counts on private enterprise to maintain employment, it must obviously provide conditions which create a reasonable expectation that profits rather than losses are to be anticipated. Confidence, and therefore business activity, can be impaired not only by injudicious government measures, but also by sound measures, the purpose of which is not clearly explained or understood. Many measures excellent in themselves may have an unfavourable influence on business activity and business enterprise, particularly on employment resulting from new private investment, because they are misunderstood. Governments have a responsibility of which they have not, in fact, in all cases been sufficiently conscious, to explain the purpose and intended effects of the measures they adopt—where that is necessary, to educate. It is our hope that the measures we suggest in the course of our report will increase and not diminish the opportunities for profit on a non-monopolistic basis. Their purpose is to associate profit with expansion. Indeed, there can be no better guarantee of a re-

turn on capital invested or of earnings of enterprise than the maintenance of employment and of purchasing power.

2. CONSTRUCTION

In most countries construction activity constitutes a large proportion of gross investment in fixed capital, and its fluctuations play a major role in the unevenness of investment as a whole. We may recall the movements of various types of construction expenditure in the United States from Table X in Chapter VIII.

TABLE XI
United States Construction Activity

	Value in \$ (000,000's)		<i>Mean Annual Deviation from average 1921-38</i>	
	1929	1932	<i>Average 1921-38</i>	<i>%</i>
Residential Construction	3,010	444	2,623	56.9
Business Construction	4,581	1,098	2,818	39.2
Public Construction	2,928	1,869	2,455	19.7

To some extent these different types of construction may be dovetailed into one another, since the labour and equipment involved is much the same. It should be possible to vary public construction in such a way as to compensate at least in part for variations in residential or business construction, though this has seldom been achieved in the past. This policy will be discussed in connection with public expenditure as a whole in Chapter XII. Variations in construction for business purposes are closely related to those in industrial investment generally and are subject to similar influences.

We shall therefore consider first the problem of stabilizing residential construction, which is frequently the most unstable element in construction as a whole and is also partly responsible for instability in other types of construction, such as roads, utilities, schools, hospitals, etc.

What steps can be taken to reduce fluctuations in residential building?

The main factors determining residential building activity are, as we have shown in Chapter IV, consumers' incomes, the age distribution of existing houses, the basic need for new houses due to population growth and shifts, and building and financing costs.

Stabilization of consumers' incomes is a central object of business cycle policy, and the more effectively this stabilization is secured, the less will be the risk of wide fluctuations in residential construction. The effect of the second factor, the age distribution of existing houses, is considerable. High building activity in one period generates a slackening of construction in the next. A stabilization policy, therefore, calls for a close watch on the current level of building activity, with a view to keeping it in step with the long-run housing needs as determined by the third factor, population growth and shifts, together with replacement demand. Governments might do much to help the trade by collecting and publishing at regular intervals all relevant statistics.

The effect of the sharp curtailment of new building in most belligerent countries during the war, combined in some cases with widespread destruction, will cause an abnormal demand for housing for many years to come. The more rapidly this demand is met, the greater the expansion of the building industry will need to be; and the greater also the contraction later on when these abnormal demands have been met. The problem of smoothing and preparing for this inevitable hump in post-war building activity may be regarded rather as a problem of transition, and therefore not properly within the scope of this Part of our Report. It serves, however, to bring out in an acute form the relationship between the existing stock of houses and current demand for new building.

(a) *Financial Costs.*

Apart from direct government control through building permits, as in wartime, the main instruments for influencing private building activity must operate on building costs. Because of the great durability of houses, capital costs play an extremely important part. Building is therefore more responsive than most other forms of investment to changes in capital charges. Changes in mortgage interest, the period of amortization, and the proportion of construction costs that can be covered by mortgage credit, all exercise an important influence on the volume of building, and may be used to check building excesses during booms as well as to stimulate building in times of subnormal activity. There are situations, of course, in which limitations imposed by the general structure of interest rates minimize the extent to which mortgage

interest rates can be used as an instrument to stabilize conditions in the private construction industry. The conditions under which mortgage loans are advanced, however, namely the period of amortization and the proportion of funds loaned, lend themselves more generally to variation in the interest of stability.

State financial agencies may facilitate the application of appropriate policies. Thus, the Federal Housing Authority in the United States of America, which was established in 1934, insures mortgages for home owners, prescribing (1) maximum ratios of loan to appraised value (originally 80 per cent), (2) maximum amortization periods (originally 20 years), and (3) a maximum interest rate (originally 5 per cent plus $\frac{1}{2}$ per cent service charge, plus insurance premium).

A modification of cyclical movements could be effected by liberalizing or tightening credit terms according to the state of building activity. The extent to which the annual charge on, for instance, a \$4,000 loan may be modified by moderate variations in interest rates and amortization periods is shown in the following illustration:¹

<i>State of Building Activity</i>	<i>Interest Rate Per Cent</i>	<i>Amortization Period, Years</i>	<i>Annual Loan Payment</i> \$
Low	4	25	253.44
Medium	5	20	316.80
High	6	15	405.12

The proportion of total construction costs that can be covered by mortgage credits, or, in other words, the amount of down payments demanded, may exercise a still more potent influence on building activity. If only government-insured mortgages were varied, however, there would be a tendency for prospective purchasers to transfer to uninsured or second and third mortgages during booms, which would partly defeat the objects of the policy, though the competitive influence of liberalizing credit terms for insured mortgages would still be effective in stimulating building during depressions. These measures could be supplemented by refusal to recognize excessive building costs in appraisals during

¹ Cf. L. Grebler, "Housing Policy and the Building Cycle", in *Review of Economic Statistics*, May, 1942.

booms, and stricter standards in appraising risk and the personal credit rating of the borrower.

We mention this case of insured mortgagés, however, merely with a view to indicating the type of service that the government could render. The mortgage banks, building societies, insurance companies, etc., which exercise so great an influence in many countries could pursue similar policies with similar effects, especially if, as we have suggested, the government kept them informed by the publication of statistics concerning marriages, population movements, vacancies, national real income, conversion and demolition of existing dwellings, construction permits granted, etc. But there has in the past been a tendency for both mortgage rates and the rate of interest offered by mortgage institutions and building societies to reflect but little changes in market conditions. In a number of countries, conditions do not permit the monetary and other public authorities easily to influence the mortgage market and legislation may be required in order to give greater flexibility to it. In any case the active cooperation of those responsible for such institutions with the monetary authorities is essential.

(b) Other Costs.

But building costs may prove a more potent factor than financial conditions. Thus the number of houses constructed in the Netherlands showed hardly any contraction during the depression of the early 'thirties, in spite of the fact that interest rates on new mortgages remained at relatively high levels (5.51% in 1929, 5.57% in 1932, and 5.03% in 1935). The explanation appears to lie in the sharp decline in building costs, which fell as much as 37% between 1929 and 1935, largely as the result of the depreciation of the currencies of foreign suppliers of certain materials such as wood, iron and cement. After the devaluation of the guilder in 1936, building costs rose and activity fell off in spite of a decline in interest rates.

Monopolistic tendencies resulting in divergencies between construction costs and other prices and incomes must therefore be carefully watched, especially as the sheltered character of the building trade renders it peculiarly liable to such tendencies. Monopolistic prices and wage rates, while injuring other sections of the economy, do not necessarily benefit those having a direct

interest in the building industry if—as is likely in most circumstances—they result in a curtailment of building output and employment. Sweden affords an interesting example of the beneficial recognition of this fact. The recruitment of labour by the building union in that country had not kept pace with the increased demand after 1926, and labour costs rose rapidly. There was a lock-out in 1933, which was followed by an agreed arrangement under which the union accepted not only wage reductions but also an adjustment of collective contracts to facilitate the introduction of new methods and new construction materials. Building activity was greatly stimulated and in subsequent years not only was the rate of recruitment in the industry increased but wage rates also were raised. The flexibility of the policy of the unions thus contributed to increased employment and higher wage disbursements.

It is no less important that the prices of building materials should be kept in line. When these materials are partly imported, the most effective means of breaking a monopolistic position would be to lower the tariffs. The effect of such a measure may well be to increase and not to decrease the demand for the domestic products, owing to the lowering of prices and the consequent stimulation of building activity in general.

(c) *Dovetailing Public Building.*

In many countries the public authorities, both central and local, are in a position to contribute materially to stability in the building industry, either by adapting their own building programmes to counteract variations in private building, or by adapting such subsidies as they may grant to the fluctuations in building.

For this purpose it is of the utmost importance that the central and local authorities should have a concerted programme. By this we do not mean that all public expenditure on building should vary to the same extent, or even in the same direction, year by year. For building is a highly localized industry, and private building may be slack in one area and active in another. But it is important that policies should be thought out in advance, and that the central government should exercise influence over the local authorities so as to assure that their building programmes are designed with a view to promoting stability both in their own areas and over the industry as a whole.

Such a system of dovetailing might at first sight appear to conflict with the primary object of a public housing policy—that of improving the living standards of the less privileged classes. If it is once realized, however, that the improvement of housing conditions by public building is a continuous process, the conflict is seen to be largely illusory; it means simply that the volume of publicly subsidized or executed construction must be decided not for single years, but for a number of years in advance. Whatever the dimensions of the programme, it should then be executed in such a way as to make the maximum contribution to stability of construction activity as a whole.

The effectiveness of the proposed contra-cyclical mortgage credit policy will inevitably depend on how far it succeeds in compensating for cyclical changes in incomes of purchasers. A reduction in the annual carrying charge on a house will not succeed in promoting new investment if incomes have been reduced more than correspondingly. Hence an important prerequisite for the effective control of fluctuations in residential building by these means is that other steps should be taken simultaneously to stabilize total effective demand.

(d) *Structural Impediments to Building Revival.*

In nearly all countries the direct costs of building have been unduly high. This is partly due to the localized, small-scale nature of the building industry and partly to monopolistic practices which have developed in many countries. "In an effort to protect themselves against the uncertainties of the market and the weakness of management, subcontractors in the separate trades frequently enter into agreements to maintain prices and control the distribution of work. Suppliers of materials do the same thing. Often subcontractors and suppliers, and sometimes the materials manufacturers as well, all join in protective combinations. Labour, following a similar course where it can, establishes its own restraints, and, to solidify the position, often joins with the subcontractors' combination acting through strikes and boycotts, as the enforcing agent."¹ The building industry has shared to a negligible extent in the advantages of modern large-scale production. Build-

¹ *The Role of the Housebuilding Industry.* National Resources Planning Board, U.S.A., July 1942.

ing is still mainly a handicraft process and materials are produced and distributed on a small scale and at high cost.

The recent experience of prefabrication on a substantial scale of houses for war workers in the United States has suggested the possibility of revolutionary changes in the cost of producing small houses after the war, at any rate in certain countries. With the benefits of large-scale production of standardized parts, the restrictions due to the localized nature of the building industry would be largely avoided. The public stimulation and subsidization of research on building materials and methods might contribute substantially to reducing building costs.

A further prerequisite of low-cost housing is the availability of land at a reasonable price, which may imply the prevention of private land speculation and the power to prevent a single house owner from obstructing some general clearance and reconstruction scheme. In connection with land speculation, we may refer to the proposals of the Uthwatt Committee¹ in Great Britain for the acquisition of land for development by a Central Planning Authority, which would purchase at the undeveloped value plus compensation for development rights. The Planning Authority would retain ownership and lease the land at rents from which the speculative element would be eliminated.

Even when building costs are low, however, a revival in demand may be impeded by high taxes on land, houses or rents, which directly or indirectly increase the cost of house room to the tenant or owner. Good housing is so important for public health and welfare, and the building industry constitutes so important and sensitive a part of total national investment in all countries, that special attention should in our opinion be paid to the need for keeping the total costs of both building and occupying houses as low as possible.

3. INDUSTRIAL PLANT AND EQUIPMENT

(a) *Influence of Consumption Expenditure.*

We must refer once more to the distinction introduced in Chapter IV between such investment as is primarily dependent on an increased demand for consumption goods and investment which is

¹ Cmd. 6386, *Expert Committee on Compensation and Betterment: Final Report* (London, September 1942, Ministry of Works and Planning).

largely determined by the discovery or development of new goods, new methods of production, or new territories. The effect of income fluctuations on the former type of investment is not always the same; it depends on the nature of the profit expectations to which such fluctuations give rise. If the existence of a more or less regular cycle in demand is taken for granted by the business community, many businesses will increase investment during depressions, when costs are low and labour available, in anticipation of a revival in demand. This procedure was probably more common in the nineteenth century when, largely as a result of population growth, there was a more confident expectation of the renewal of the upward trend in production and investment, rendering depression periods on the whole shorter and less marked than periods of expansion. The exceptional length and severity of the depression of the early 'thirties has tended to shake faith in the inevitability of recovery, and thereby changed the relationship of profit expectations to current demand. A fall in current profits consequently may lead to a fall instead of a rise in future expectations, with the result that this type of investment is less likely to revive during depressions. A publicly declared policy of maintaining effective demand might in certain countries do much to change this situation. If business men come to have confidence in the intention and ability of the Government to maintain total income, a recession when it occurred would be regarded as purely temporary and lead to a renewal of investment in anticipation of recovery, to which such investment would itself contribute. But it cannot be expected that such confidence will be quickly or lightly won.

(b) *Importance of Rising Consumption Expenditure.*

Moreover, this is not the whole problem. As already explained, the rate of new investment is related to increases in consumption expenditure, and not to its absolute level. Hence, while stability of total demand may help to mitigate fluctuations in the replacement demand for capital goods,¹ it cannot ensure a stable demand for net new investment. For this purpose a steady rate of increase in the demand for final goods is required. The practicable rate of

¹ It has been suggested that stability or a contra-cyclical movement of replacement demand might be further promoted by varying the depreciation allowed in computing tax liability during the course of the cycle.

increase in the demand for final goods is necessarily limited by the rate of increase in national income as a whole, together with the possibilities of income redistribution. Hence, stability in that part of investment which is dependent on an expanding demand for consumers' goods means that the rate of such investment must be kept within the limits of the probable or potential increase in demand. If output of capital equipment increases more rapidly than the demand for its products, a slump will inevitably follow. As far as this type of investment is concerned, therefore, the checking of undue expansion is no less essential for promoting stability than for stimulating recovery during depressions. In practice it is naturally difficult to decide when an expansion is excessive, but some attempt may be made in the light of current investment and of past experience of the trend of consumers' demand. The appropriate means for preventing undue expansion in a particular capital goods industry must depend on the situation in that industry. If the over-investment is widespread, financial measures may be appropriate. In the case of a tendency to over-expansion in only one or two industries, however, credit restriction would be too wholesale a policy and might precipitate a general depression.

(c) Long-term Planning of Investment.

The first essential is, of course, that business men should realize that the adoption of a long-term investment policy is in their own interest. The central authorities should for their part seek to provide the conditions which make it possible for producers to regularize their purchases of capital equipment. With this end in view, they should keep the public constantly informed of the general pattern of national capital equipment and of the changes which it undergoes as a result of additions to it or of losses which it suffers. The regular provision of accurate and up-to-date statistics relating to the amount and age composition of the existing stock of plant and equipment in the various industries and of consumers' durable goods such as houses, and to the amounts being currently added, replaced or retired, would enable business men to take a broader view of investment policy than that afforded by

the condition of their own plant and equipment and by their own order books.¹

Without subjecting the economy to the general pervasive effects of a rise in the long-term rate of interest, the banking authorities of certain countries have been able to prevent over-extended positions from arising in particular sectors of the economy by informal discussions with the business men concerned. Close scrutiny by banks, as well as by issue houses and investors, of the purposes for which new funds are borrowed, of the existing capacity and rate of expansion of the industry, of the probable trend of demand, etc., contribute to the same end. What is perhaps most required is that all those who exercise any influence over the provision of capital equipment to industry, or the terms on which funds are made available, should be imbued with a far-sighted outlook and a sense of responsibility for regularizing the flow of such goods and so contributing to economic stability.

(d) *Dovetailing Capital Exports.*

Investment in capital equipment like construction affords an opportunity for dovetailing. The demand for additional machinery in industrial states is to a large extent dependent, as we have just said, on the rate of growth of consumers' demand for finished products. But there is, we believe, a very great untapped potential demand for manufactured goods in less developed areas which could be rendered effective if such goods could be furnished at a low enough price, and especially if purchasing power in these areas were expanded by foreign investment. Indeed, the gradual spread of a money economy throughout the world has largely taken the form of bringing manufactured consumers' goods within the range of the purchasing power of these low agricultural income groups. There would be a real benefit both to the makers of machinery in industrial states and to these less developed areas if capital exports could be adjusted to fluctuations in the activity of the machine and similar capital goods industries, stimulated when that activity declined and slackened when domestic demand

¹ A beginning in this direction has recently been made in the United States. See, for example, a series of articles by George Terborgh in the *Federal Reserve Bulletin*, especially those in the September 1939 and October 1940 issues, entitled respectively "Estimated Expenditures for New Durable Goods, 1919-1938" and "Present Position of the Durable Goods Inventory".

was active. Such a policy would help to stabilize employment in these industries and would permit the importers of the machinery both to borrow at lower rates of interest and to purchase at lower prices. To effect it, some central direction over capital export or some state insurance of export credit might be required in certain countries—such control and insurance have existed in the past. Were they employed in a contra-cyclical manner, risks would be reduced, and the charge upon governments on account of unemployment insurance might be very substantially curtailed. The active co-operation of the central banks of the importing countries might be required and should be readily available. For these monetary authorities have been subject to difficult strains in the past owing to the fact that foreign capital tended to flow to their countries in good times and that this flow tended to be arrested and the volume of outstanding short-term capital to be reduced when business fell off. In this way the pressure to which their exchanges were subject in any case owing to the fall in the prices of their products was enhanced. We are not unaware of the difficulties of pursuing such a dovetailing policy. Obviously it is important that large-scale projects should not be interrupted either in good times or in bad times. In the case of projects which will require a considerable time for their completion the steadiness of the flow of the necessary foreign capital may be a more important consideration than those we have in mind.

(e) *Taxation of Risk-bearing Capital.*

Another important factor influencing both the cost of financing investment and the willingness to undertake investment is taxation, particularly in times of depression when the business horizon is cloudy.

We deal with fiscal policy in general in Chapter XII, but there are certain aspects of fiscal policy which we wish to discuss here. The great dynamic force lying behind the industrial progress of the nineteenth, and in most countries of the twentieth, century has been the willingness of the entrepreneur to take risks. All new enterprise involves risk and requires a spirit of adventure. Many of the greatest undertakings in existence today began owing to the foresight and initiative of a single individual and his freedom to expand his business from small beginnings by reinvesting his sav-

ings in it. Others have depended on relatively small individual contributions of capital by persons who were willing to venture a part of their capital on the chance of a large return and with the risk of a complete loss of that part. The highly geared taxation of recent years has, however, tended to dry-up what was the most important source of risk capital, namely, large private incomes. Persons with more moderate incomes are not in a position to provide this type of capital and new types of financial institutions may have to be developed to help fill this gap.

In some countries certain forms of taxation have accentuated the unwillingness to undertake risky investments. High income and capital gains taxes reduce the reward in the case of success with no corresponding compensation in case of failure. Moreover, when to personal income taxes are added corporation taxes, a form of domestic double taxation is created, which, when rates are high, so reduces the prospect of profit as to constitute a serious deterrent to enterprise. When the state is compelled to drain off any large proportion of the national income by means of direct taxes, it may prove impossible to avoid such double taxation altogether, for the total abolition of corporation taxes is likely in such cases to render an increase in personal income taxes unavoidable. But high taxes on the profits of industry not only check enterprise, but have the further disadvantage of causing an inducement to financing by debentures, that is, by debt, rather than by equity. Since debentures naturally escape corporation taxes, their service constitutes a liability against gross profits. Though present rates of taxation will no doubt be reduced we do not anticipate that it will prove possible to do away with high taxes on large individual incomes and indeed we suggest in later chapters that high taxation may in certain circumstances be a necessary instrument for the achievement of economic stability. Some mitigation of the discouragement to risk-bearing may, however, be offered by permitting for tax purposes the deduction of losses from corporation profits, not only in the year in which they occur, but over a series of years. But, in addition to granting this alleviation, fiscal authorities would, in our opinion, be well advised to realize that high corporation taxes may constitute a serious impediment to enterprise and a check to economic progress.

A further stimulus to the adoption of new processes as well as

the introduction of new industries can be given by permitting rapid amortization of capital and full allowance for obsolescence in computing tax liability. Some tax authorities exempt new undertakings from taxes altogether during the first years of their existence. Exemption from taxation on earnings is, we feel, preferable to subsidies in such cases, as it gives a greater guarantee of sound management. If there are no earnings there is no benefit from exemption.

Partly in consequence of the drying up of other sources of risk-bearing capital, new invention has been developed to an increasing extent since the last war through the reinvestment of company earnings by existing enterprises. This tendency has also been accentuated by the advantage large corporations enjoy in being able to afford considerable research staffs. To the extent that undistributed profits are subject to special taxation this source of risk-bearing capital is likewise depleted.

Apart from the various measures designed to relieve the tax burden on risk-bearing, steps may be taken to reduce the risks themselves. Probably the most important deterrent to investment in the immediate pre-war period was political insecurity, and to this fear was added fear of depression. This fear of depression could, in the long run at any rate, be largely alleviated if the government were openly to accept responsibility for endeavouring to maintain a high and stable level of employment.

(f) *Prices of Capital Goods.*

Finally, we would draw attention to the importance of the prices of capital goods in influencing the volume of investment. Changes in these prices have effects similar to those resulting from changes in the rate of interest; and prices are probably of even greater importance than the rate of interest in determining the volume of investment in the manufacturing industries. Prices of capital goods are frequently subject to private monopolistic controls which endeavour to maintain them at relatively stable levels. If these controls are successful in doing so and the prices of finished capital goods are kept relatively stable in the face of wide variations in the demand for them this contributes to the stimulation of capital investment in prosperous periods and to its retardation in depressed periods and so accentuates cyclical fluctuations.

Such stability of prices may have, on the other hand, a general stabilizing influence in certain cases; indeed, the prevention of wild fluctuations in the prices of raw materials must be a major concern of governments in their endeavour to avert depressions. But any attempt to reap large returns on a small turnover, rather than smaller returns on a larger turnover, which the monopolist is often in a position to do, may effectively prevent recovery or check progress.

We deal with the general question of raw materials in other chapters. The most effective instrument in the hands of governments, as regards finished capital goods, is, in most countries, the tariff. The governments can and, in our opinion, should lower tariffs whenever investment is being impeded by the refusal of any private monopolist to adapt prices to the conditions of the market.

(g) *Dovetailing Public Expenditure.*

It is improbable that fluctuations in private investment can ever be completely eliminated. This does not, however, mean that corresponding fluctuations in the level of employment as a whole are inevitable. It means only that every effort should be made to vary other items of expenditure such as public investment and private consumption in such a way as to compensate for the fluctuations in private investment. If total demand is maintained in this way, it should be possible substantially to mitigate the fluctuations in private investment itself, and thereby reduce not only avoidable unemployment, but the waste and excessive costs resulting from unused capacity, and constant shifting of labour.

4. STOCKS OF COMMODITIES

Stocks of commodities constitute the third category of investment with which we are concerned. Though constituting a small percentage of domestic capital formation, they are its most unstable element.

In our discussion of the role of stock policies in Chapter IV, we found two types of policy which tend to accentuate cyclical movements. The first was that of maintaining a constant ratio of stocks to sales on grounds of convenience; the second, was that of accumulating stocks in anticipation of a price rise or liquidating

them when a fall of price was expected. It is obvious that any policy designed to stabilize the national income would contribute substantially to the reduction of both these types of stock variation, by eliminating or reducing the fluctuations in sales and in prices on which they are respectively based.

Measures designed more directly to reduce or prevent wide fluctuations in the prices of raw materials would further diminish the incentive to speculative investment and disinvestment in stocks. The use of international buffer pools for this purpose is discussed in Chapter XIX below. But speculation of this type may be caused by sudden increases in wage rates if these are unrelated to increases in productivity and are expected to raise the prices of partly processed goods such as smelting products. In this case the preventive action required is national and not international.

To the extent that stocks of goods are held on credit, the cost of credit exercises an influence over the quantities held; the importance of this influence in the total costs of holding stocks varies for different commodities—storage charges, for example, are much more important than the cost of credit for many commodities. But when conditions permit an attempt might be made to check tendencies towards over-accumulation at an early stage by stiffening short-term rates, and to counter the excessive liquidation of stocks by easing rates. So long, however, as prices and costs fluctuate within a range very much greater than that of short-term rates, so that the anticipated gains or losses to be derived from holding stocks remain large, it is doubtful whether credit policy by itself will be able to exert any strong selective control in this field. It is no doubt true that there is some short-term rate which would curb speculation in stocks, even if large price increases are anticipated. But this rate may be so high and may have to be maintained for so long, that it would cause an all-round rise in interest rates and decline in capital values, and bring about a general contraction in investment even in those fields where it had not hitherto been excessive.

But even if cyclical stock variations by private dealers cannot be eliminated, public authorities should endeavour for their part to adopt a contra-cyclical policy, allowing stocks to increase during bad times and to fall in periods of activity. A policy of this

sort is already followed individually by many manufacturers who produce for stock during periods of slack demand and let stocks run down when demand expands. All these measures could be reinforced by public statements drawing attention to the statistical position.

CHAPTER XI

CREDIT POLICY AND THE STABILIZATION OF TOTAL EXPENDITURE

1. SCOPE AND IMPORTANCE OF CREDIT POLICY IN DEPRESSIONS

Regulation of interest rates and of other conditions affecting lending and the volume of credit, especially bank credit, has been the traditional over-all policy for influencing the aggregate flow of national expenditure and income. A reduction of interest rates and liberalization of other terms of lending was thought to promote a general expansion, while a rise in rates and tightening of other conditions would tend to check expansion or bring about contraction. In the past, emphasis was laid on the stabilization of the price level, but it is now generally agreed that what matters is rather the volume of expenditure and income, of which prices are only one symptom—and not an unfailing one at that.

Credit policy, if effective, operates on aggregate expenditure mainly by directly influencing private investment, including expenditure on durable consumers' goods. It may, however, directly influence to some extent public expenditure, especially of local authorities, by making it easier for them to borrow, and also private consumption on non-durable goods. Indirectly it influences the latter, of course, very quickly as soon as investment is affected. It thus operates on a wide front and pervades the whole economic system.

There is a tendency today to attach less importance than twenty years ago to interest rates and other instruments of credit policy for relieving depressions or stabilizing business. This change in attitude is largely due to the experience during the Great Depression in the 'thirties. In some highly industrialized countries interest rates on most classes of credit remained extremely low for a number of years and a high degree of liquidity prevailed, apparently without much influence on economic activity. This experience has made economists sceptical concerning the possibility of arresting a contraction and inducing an expansion by means of easy money and credit policies, although they still admit that an expansion can always be halted and turned into a depression, if credit is sufficiently restricted and interest rates raised. The role

assigned to credit policy is thus rather that of a brake than of an accelerator.

We for our part doubt whether it is possible to check a depression in highly industrialized and financially developed countries by credit policy alone. But that does not mean that credit and banking policies are unimportant. First, in industrially and financially less developed countries, or even in some highly developed countries, interest rates may be sufficiently high after the war to allow for significant reductions in depression; hence the effectiveness of general credit policies in a depression may still be considerable. Secondly, even in the industrially and financially highly developed countries there are certain classes of credit, for example, real estate credit and consumer instalment credit, where interest rates are still high, other conditions of lending onerous and credit not always easily available. Under these conditions there is still scope for effective credit policy in depressions. Some of these special cases have already been discussed in the two preceding chapters. Moreover, general banking policy, using the traditional weapon of the discount rate, open-market operations and the more modern device of changing the legally required cash ratios of commercial banks, even if incapable by themselves of turning the tide of a depression, can bring about a high degree of over-all liquidity, which is a favourable or even essential condition for the inception of an expansion. It thus provides the monetary conditions which are necessary for the success of the more powerful measures of fiscal and other policies proposed in other chapters of the present Report as well as for the development of spontaneous forces of expansion. Furthermore, even in the most highly developed countries recent depressions have been much intensified by purely financial developments, such as the striking wave of bank failures in the United States in the early 'thirties which undoubtedly contributed much to the special severity of the depression during the 'thirties. It is clearly the responsibility of the monetary and banking authorities to prevent such occurrences.

The general objectives of credit policy and banking during depressions may therefore be summarized as follows: to prevent a rise in interest rates, credit stringency, bank failures and panics; to reduce interest rates as much as possible and make credit easily available; to increase general liquidity, especially of banks, of

other financial institutions and of business in general. Whether interest rates can be reduced significantly depends, of course, on their level during the preceding upswing. In view of the fact that there are certain limits below which it is hard to depress rates if lending institutions are to cover their overhead costs, not much can be achieved if rates are already close to this lower limit. This seems to be the situation at present in some of the rich industrial countries over large areas of credit though not everywhere. But whatever the situation may be in that respect, it is important to observe that liquidity can be increased (or decreased if necessary), even if interest rates can no longer be reduced significantly. The availability of credit is not exclusively a function of the rate of interest. Even in fields where the interest rate is low changes in practices and standards of lending may change the availability of credit.

2. INSTRUMENTS OF CREDIT POLICY

Various instruments are at the disposal of the monetary authorities for regulating the volume of credit. Through discount policy the price of short-term credit can be controlled and this will sooner or later have an influence also on long-term rates. Both the price and the quantity of certain short- and long-term credit can be influenced by open-market operations in short- and long-term securities. There have been occasions when the mere declaration of monetary policy has been effective in bringing about desired conditions. Direct though informal suasion by central banks can influence the lending policy of commercial banks. Changes in reserve requirements and qualitative controls of the uses to which credit is put, through, for example, changes in margin requirements on stock-exchange loans, are powerful instruments of credit policy. Regulation of instalment credit and mortgage loans through changes in the size of the minimum down payment and the maximum period of amortization have already been discussed in connection with other policies concerning the particular classes of expenditure on which they operate.¹

We discuss below the efficacy of some of the instruments we have mentioned and certain special problems connected with them. It should be remembered, however, that the freedom of the monetary

¹ Chapters IX and X.

authorities of any country to pursue these policies is limited by their effects on the foreign trade and foreign exchange position of the country concerned. We shall ignore these limitations in the present chapter and reserve them for extensive treatment along with other international aspects of depression policies in Chapter XVII.

(a) *The Discount Rate.*

The traditional instrument of monetary control is the central bank discount rate. The central banks and other monetary authorities can generally exercise a direct influence on the level of short-term rates prevailing in the market. The cost of certain types of short-term business borrowing can therefore be determined to a large extent by central bank (or government) policy. It is difficult to determine how important a part is played by variations in the cost of short-term borrowing on the decisions of business men to borrow and spend. With the increasing use of capital in modern production, there seems little doubt that less of total business borrowing has been at short-term and more at long-term. A century ago, a change in the bank rate would directly influence the cost of the great bulk of business borrowing, whereas today, in the more advanced industrial states, when, in addition to capital issues, so much of the capital used in business is provided from accumulated profits or through insurance and building societies and other institutions specializing in long-term commitments, the direct influence of a change in the bank rate is felt over a relatively smaller area. Its importance is greater in countries less highly capitalized so long as the central banks of these countries have effective control over the money market. These countries will frequently find that the fiscal and other policies we suggest for smoothing out the business cycle present greater difficulties than they would in richer communities and be forced, therefore, to make greater use of banking policy. Moreover, the rates of interest in these countries are likely to be high enough to afford sufficient elasticity to render changes in the bank rate influential.

Today, the part of business borrowing most affected by changes in short-term rates is probably the financing of stocks of commodities. But even in this field, as we pointed out in the preceding chapter, the influence of a reduction in interest rates should not be

overestimated; it can be easily blotted out by unfavourable price expectations.

We cannot be sure, however, that these limitations to the effectiveness of bank credit will be permanent. Commercial banks continue to hold a strategic position in every money market; they have the ability to change the focus of their lending activities and to pioneer in new financial techniques. In the United States just before the war, for example, commercial banks were actively developing "term loans" to large industries and were experimenting with methods for the medium-term financing of small industries. In certain countries an unduly high proportion of short-term deposits has, it is true, been tied up in long-term assets with unfavourable reactions on banking stability. If not pushed too far, however, the developments to which we have just referred would have the effect of bringing short and medium interest rates and other conditions of credit more directly under the influence of central banks which would thus acquire a more effective control over the rate of business investment.

(b) Changes in Cash Ratios.

In certain countries the central monetary authorities are also empowered to exercise an influence over credit policies by altering the cash reserve requirements of the commercial banks. This instrument—like other instruments of credit policy—is particularly effective in checking a boom and is of special value in those markets in which a few banks have such a predominant position that they may expand credit without incurring the danger of large losses of reserves to other institutions. We shall revert again to the problem of credit policy during a cyclical upswing.¹ The utilization of this measure in depression depends on prior use having been made of it in the other direction, for there are obvious limits to the possible reductions in reserve ratios.

(c) Open-market Operations and Interest Rates.

Through open-market operations a central bank or a monetary stabilization fund is able to alter the volume of cash reserves of the commercial banks and their power to make loans and acquire investments. In certain countries open-market operations are car-

¹ See section 3 of present chapter.

ried out in medium- and long-term government bonds as well as short-term Treasury bills and, therefore, exercise a direct as well as an indirect influence on the medium- and long-term rates of interest. We believe that it would be very desirable to take legislative measures empowering central banks to extend their open-market operations over longer maturities and different types of securities.

An increase in the cash reserves of the commercial banks by open-market operations during a depression renders it unnecessary for them to sell assets or call in loans in order to replenish their reserves—a process which might exert a deflationary influence on prices and incomes by causing forced sales. It also puts banks in a position to use their cash resources to buy government and other securities, and so contribute to a decline in the long-term rate of interest. The provision of ample cash enables them to satisfy their desire for liquidity without indulging in behaviour which—no matter how sound or necessary it may be from the point of view of each individual bank—is ruinous for the economy as a whole.

Greater availability of capital in the long-term market enables business men to fund their outstanding short-term obligations, including bank debts; thus frozen bank loans tend to be thawed and in consequence total bank advances to decline. This reduction in short-term indebtedness plays an important part in stimulating business confidence and the willingness to spend. When the pressure to use available incomes to pay off bank loans is removed, business men are more likely to make needed repairs and replacements, build up depleted stocks of goods and spend money in other productive ways.

In certain countries the loan rate of the commercial banks appears to be influenced too much by convention and to follow the yield on government bonds only very imperfectly and with a long time lag. In such cases it would be desirable that the monetary authorities should exercise their influence with a view to rendering this rate more flexible. In this connection it is necessary to watch carefully the rate paid by savings banks on savings deposits. Failing this, commercial banks may suffer a large transfer of deposits to savings institutions when market rates of interest are low, or competition for savings deposits may force the commercial banks

to charge relatively high rates on loans and overdrafts if they are to cover their overheads.

The influence of the central bank over the lending and investment policy of the commercial banks varies from country to country. It is greatest in those countries in which the commercial banks normally work to a stable cash reserve ratio, for relatively small changes in the commercial banks' cash reserves result in multiple purchases or sales of assets and may have important effects on certain types of interest rates. To take but one example, the increase in the cash reserves of the London Clearing Banks from an average of £182 million in 1931 to an average of £215 million in 1935 was accompanied by an increase in their holdings of securities from £301 million to £615 million.

The commercial banks of different countries are, of course, geared to different rates of expansion; and if the cash reserves of the commercial banking system are increased at an exceptionally rapid rate, it cannot be expected that the banks will always be able to add quickly to their loans and investments in the same proportion.

It must also be noted that the commercial banks of certain countries work to a fairly stable ratio not only of cash to deposits but also of quick assets to deposits. Close attention must, therefore, be paid by the monetary authorities to the available supply of such assets. For if a bank works, for example, to a 30% ratio of cash, call money and treasury bills to total liabilities, and if funding operations produce a scarcity of treasury bills in the market, then additions to the commercial banks' cash reserves will fail to exercise the customary multiple expansionary effect.

It is quite likely that after the war, especially in some of the rich, industrially highly developed countries, the efficacy of open-market operations in depressions through reducing interest rates will be negligible, for the simple reason that the rates will hover around very low levels even in prosperous years, so that there will not be much opportunity of reducing them significantly in depressions. The enormous growth of the public debt and the fact that banks are large holders of government securities will make the monetary authorities extremely reluctant to let rates rise and prices of fixed interest securities fall in prosperous periods.

In spite of this we still attach importance to open-market opera-

tions (and other credit policies) for two reasons. First, there will be countries with sufficiently high interest rates to make their reduction in depressions a not insignificant factor. Even in some industrially developed countries tremendous capital losses during the war and enormous capital demands for reconstruction may drive up interest rates and keep them there beyond the period of transition. In some countries the public debt may be wiped out or sufficiently reduced by inflation to eliminate it as an obstacle to a rise in interest rates. Secondly, as we remarked before, an increase in general liquidity which can be achieved by open-market operations, even if interest rates do not change significantly, will provide a favourable or even necessary (although frequently not sufficient) condition for an expansion brought about by other policies or by spontaneous forces.

3. CREDIT POLICY DURING A CYCLICAL UPSWING

The questions of policy, especially the dangers of inflationary price rises, which present themselves when the economy approaches full employment will be more fully discussed in Chapter XIV. But there are a few observations on the proper credit policies during a cyclical upswing which we wish to make at this point.

General policies of credit restriction are not necessary so long as an expansion proceeds without sharp price rises and speculative excesses. A moderate price rise is a usual characteristic of an expansion and can hardly be avoided. A mechanical stabilization of prices, or attempt at stabilization, would hinder expansion without preventing contraction. It is difficult to determine the point at which a price rise should be regarded as so excessive as to call for a measure of control. But there is good reason to assume that danger exists and restrictive measures should be contemplated, if the price rise becomes speculative, if it feeds upon itself, people buying simply because they expect prices to go higher. However, much will have to be left to the judgment of the authorities on each case as it presents itself in the full light of the underlying situation.

A sharp general rise of prices is not likely to occur before a high level of employment is reached in wide areas. But it may happen, if wages are pushed up too quickly by union pressure and other costs are raised by monopolistic actions or deliberate government

policies. The development in the United States in 1936-37 may be a case in point. In such a situation it is clearly much better to stop the special forces which drive up prices and costs by exercising the necessary influence on labour and other monopolies and by reversing cost-raising government policies, than to restrict credit all round. The latter policy, if sufficiently strong to check the rise in prices will, by the same token, also stop the expansion of output short of a high level of employment, or even bring on depression.

Special care should be taken to deal with price rises and speculative excesses in particular areas by means directed to removing the particular maladjustments. This would avoid general measures of credit restriction until resources have been so fully employed that a further expansion of demand threatens the economy with inflationary price rises. It would clearly be a mistake to raise interest rates in general, restrict credit all round and bring about a general depression in order to curb, for example, a real estate boom in a certain part of the country or speculative excesses on the stock exchange while full capacity output has not been reached generally. Methods of selective and qualitative control should be used and developed—methods of dealing with certain branches of credit such as real estate credit, consumer instalment credit, stock exchange credit, which permit credit being restricted to these purposes without forcing a general contraction of credit. If there are inflationary developments in these fields conditions concerning margin requirements, down payment percentages and amortization periods should be tightened and interest rates should be raised when this can be done without undue disturbance to the general monetary policy being pursued.¹ These various measures should be used the more freely whenever necessary because, if credit conditions are not tightened in these various ways to curb speculative price rises, it will not be possible to relax them during periods of depression and control of an important instrument for combating depressions will have been lost.

The same holds true of interest rates and credit in general. If credit is not restricted and interest rates are not allowed to rise to curb a monetary expansion after a high level of employment has been reached and prices in general have started to rise sharply,

¹ Concerning mortgage credit and consumer instalment credit, see also Chapters IX and X.

these credit weapons to counteract depressions will have been lost. We have already mentioned the fact that the tremendous rise in the public debt and large holdings by banks of government securities will, in some countries, make the authorities extremely reluctant to tighten credit in times of booming trade. We do not wish to argue the case for and against the policy of keeping interest rates down under all circumstances. But there is one point to which we should like to call serious attention. The less use is made of credit instruments the more will it be necessary to rely on fiscal policies or, if these cannot be adopted promptly, on all sorts of direct control such as price fixing, direct investment controls and allocation of productive resources for the purpose of preventing inflation.

CHAPTER XII

PUBLIC EXPENDITURE AND FISCAL POLICY

1. OBJECTS OF PUBLIC EXPENDITURE

Views on the proper functions of public expenditure and fiscal policy have undergone a remarkable evolution. According to the laissez-faire ideal of the neutral or negative role of the state, public expenditure was regarded as wholly unproductive, as a necessary evil, resulting from the need to keep internal order and provide defence from foreign aggression. This view could be summed up in the famous "golden maxim" of Jean Baptiste Say, that "the very best of all plans of finance is to spend little, and the best of all taxes is that which is least in amount". Not only should taxes be small, but they should also be as neutral as possible in their effects on the price structure and the distribution of income.

The view that public revenues and expenditures should be neutral in their effects on the economic structure depended essentially on the premise that government revenues and outlays as a whole should be small. It was consistent with an economic and social structure in which the total revenues and expenditures collected and disbursed by the state did not exceed a minor fraction, say 5 to 10 per cent, of the total national income. In such a structure, the aggregate of public levies was not so large as to be a major factor in the level of costs, nor was the aggregate of public expenditures sufficiently large to be a major factor in the level of employment. When these circumstances prevailed, there was considerable further cogency in the argument that, from a practical standpoint, the simple principle of "neutrality of effect" in the management of public finance constituted a salutary guide for fiscal authorities, since at the best society stood to gain little from an abandonment of that principle in favour of a more complicated formula, while it might possibly lose much were there fiscal mismanagement.

This view led in its turn to the principle that budgetary equilibrium should be achieved annually. It provided both legislative bodies and the electorate to which they were responsible with a simple rule of thumb by which to gauge their freedom of action, their duties and their responsibilities. By insisting that the same

legislative body which voted new or increased expenditures—which are likely to be politically popular—must also undertake the unpopular responsibility of levying the new or increased taxes to meet them, it provided a semi-automatic mechanism to ensure a responsible attitude toward public finance, a mechanism, moreover, which served to eliminate fiscal measures of the “panacea” type from serious legislative consideration. Though the operation of this rule of thumb might, in periods of depression, act to decrease public outlays or to increase taxes, or both, the actual effect of these actions in accentuating a depression was minimized by the relatively small magnitude of the amounts involved, and in practice was more than likely to be offset by the fact that so long as budgets were balanced there was no danger that the propensity to invest, already weakened by a low current rate of profits, would be further undermined by fear over the soundness of the public credit.

In practice there were always many departures from this *laissez-faire* view, and by the end of the nineteenth century a subsidiary function of public expenditure and the fiscal mechanism as an instrument of social policy was widely accepted. Expenditure on social objects such as education, health, etc., and in a number of countries public services, such as railways, was admitted as beneficial and at least “socially productive”; while the substitution of the principle of ability to pay for that of equal sacrifice, reinforced by the exigencies of war, led to increasingly progressive and redistributional tax structures. In general, up to the period of the Great Depression of the 'thirties, every effort was made to maintain the principle of an annual balance in the budget.

A much more drastic change in views on fiscal policy has developed during the last pre-war decade, mainly as a result of increasing concern with the problem of stability and unemployment, with the incidence of fiscal outlays on the business cycle. Until the 'thirties monetary policy was regarded as the main instrument for stabilizing business conditions, the effect of public outlays themselves being relegated to a minor position. Partly as a result of the practical necessity of relieving unemployment by government expenditure and of other public measures inaugurated during the 'thirties to combat depression, emphasis has tended to shift from monetary to fiscal policy, which has come to be regarded in a new light as a possible major instrument for securing fuller employ-

ment of the national resources. Particularly as a result of the war, it has become clear that government expenditure may create employment in the same way as private expenditure and that private expenditure itself may be influenced by the level of government expenditure. The increase in the role of government has also been accompanied by new examination of the tax structure. The whole problem of management of public finance is consequently now under review, including the extent and nature of taxes collected, the character and level of public expenditures, the role of the public debt, and the relation of all of these factors to budgetary equilibrium, particularly in their effects upon the business cycle.

2. CONTRA-CYCLICAL MANAGEMENT OF PUBLIC FINANCE

The necessity of maintaining confidence in the public credit and the risks of fiscal mismanagement in the form of corruption of public officials, political favoritism or such outright abuse of the fiscal function as to lead to inflation are well documented and do not need elaboration in this Report. These are risks, however, which under present conditions must be faced directly in most highly-industrialized countries. As a result of developments in recent years, fiscal authorities have now to find taxes to yield amounts equivalent to 20, 30 or an even higher percentage of the national income. In these circumstances it becomes impossible to devise levies that will not profoundly influence costs of production and the volume of private spending. Even taxes on incomes and profits, which have probably the smallest direct effect upon costs, will exert a major influence on decisions to invest, hoard or disinvest when the rate of taxation is high. Likewise it is impossible to ignore the effect of the level of, or the changes in, public expenditure on employment when a large proportion of the real income of the community is provided by the state either in the form of free services such as education, roads, etc., or in the form of such social services as unemployment insurance, old age pensions and family allowances.

Given these conditions it becomes practically impossible to achieve budgetary equilibrium on the traditional annual basis without serious accentuation of other existing tendencies toward cyclical instability of business. An adequate revenue system based wholly on taxes with a relatively stable yield in depression as com-

pared with prosperity, for instance taxes on real estate, would be difficult to achieve. Even if it could be achieved, however, it would be likely to exercise a destabilizing influence. Real estate taxes, for example, absorb a much larger proportion of rental incomes in depression when vacancies exist, and incomes and rents are reduced, than in periods of prosperity. They act, consequently, as a much greater deterrent to new construction. A revenue system, on the other hand, based on levies such as income taxes, the collection of which is more neutral or less destabilizing as between prosperity and depression, will ordinarily show large cyclical variations in yield. Governments clearly exercise a destabilizing influence when they vary their own outlays in accordance with such fluctuations in revenue, that is, when, as has frequently happened in the past, they expand their services and undertake new public construction in years when tax receipts are high and retrench when revenues fall.

We have observed above that this dilemma does not exist in acute practical form when the proportion of public expenditure in aggregate outlays is small. It is only when this proportion rises to a significant fraction that the necessity for choosing positive policies of fiscal management presents itself in inescapable form to public authorities. This situation became increasingly characteristic of most modern highly industrialized countries in the period between the wars. It is impossible to forecast at this time the exact position of the state in the economic and social structure once the reconversion period has passed, following this war. Most trends, however, indicate that the area covered by state activities will be larger rather than smaller than it was in 1939. It is the view of the Delegation, therefore, that fiscal authorities would be well advised to increase greatly their emphasis

- (a) on taxes with a minimum de-stabilizing effect,
- (b) on expenditure policies that provide, so far as is practicable, for the concentration of public investment expenditure in periods of depression, and
- (c) on seeking to counteract fluctuations in private spending by budgeting for deficits when such spending is abnormally low and for surpluses when it is abnormally high.

All three of these suggestions imply forms of fiscal management in which experience is relatively limited. It is possible, however, to indicate in broad outline the considerations that are in-

volved in making these policies effective and in guarding them against mismanagement and abuse.

3. CONTRA-CYCLICAL BUDGETING AND MONETARY CONTROLS

The foregoing discussion raises first the problem of administrative fiscal control. If governments are to adopt contra-cyclical fiscal policies involving budgetary surpluses in periods of prosperity and deficits in periods of depression a substitute must be found for the administrative discipline hitherto imposed by the concept of an annual balance in the budget. It is necessary to emphasize that any system of long-term budgeting over the business cycle must be placed under strict administrative control, if fiscal abuses, deterioration of public credit and serious distortion of the economic structure are to be avoided. Some beginnings, however, have been made; capital outlays are now frequently budgeted separately from current outlays, and social security revenues such as unemployment and old age insurance contributions are frequently placed in special trust funds for independent administration. In Finland, before the war, a special reserve was established out of current revenues to finance special expenditures during depressions. In Sweden, a deficit was allowed on the ordinary budget in the years of depression, and the surpluses realized after 1935-36 were used to repay the indebtedness thus incurred. To guarantee that the deficit borrowing would not be forgotten when business conditions improved, a system was introduced whereby 20 per cent of the total deficit of each year was regarded as current expenditure which had to be covered from taxation in each subsequent year. These are interesting experiments, but they were interrupted by the war and many problems of administrative control remain to be put to the test of further experience and will require careful consideration by fiscal authorities.

Administrative budgetary control must be combined, moreover, with appropriate monetary policies. When long-term budgeting is adopted, it is essential, not only that a true surplus of revenue over expenditure be realized in good times, but also that this surplus be administered in such a way as genuinely to counteract the tendency towards an inflationary price rise. This may be accomplished by devoting the surplus to debt retirement. But in some circumstances debt retirement may not be appropriate, since, for example, in a

boom characterized by serious over-investment in producers' goods the retirement of public debt held by potential investors in such goods would serve directly to augment the funds at their disposal and thus help to accentuate the existing condition of disequilibrium. In such circumstances, it might be preferable to leave surplus public funds on deposit with the banks provided the banking reserve situation was such as to ensure that this resulted in a net transfer of deposits from active private accounts to an inactive government account. Alternatively the surplus funds might be used to retire debt held by the banks, provided that the bank reserves thus released were absorbed by appropriate open-market operations on the part of the central bank. Similarly, public fiscal policies in periods of depression must be combined with appropriate monetary policies to ensure that the funds released result in an effective expansion in the purchasing power of the community.

4. VARIATIONS IN REVENUE AND VARIATIONS IN EXPENDITURE

As noted above, the fiscal policies pursued by any government exert a stabilizing or destabilizing influence both through revenue and through expenditure. The types and rates of taxes or other revenues collected, with their changing incidence on the cost structure under conditions of depression as compared with prosperity, affect both the volume of funds available for consumption and investment and also decisions to consume or invest. The volume of public expenditure likewise affects the level of employment, not only directly through its contribution to the aggregate level of expenditure but also by its influence on decisions to consume or invest. It follows from this situation that contra-cyclical changes in the government's contribution to aggregate national expenditure, calculated to affect and counteract cyclical fluctuations in business activity, can be brought about by either or both of the following two methods: (a) cyclical variations in revenues, (b) cyclical variations in government expenditures either from taxes or from other sources. Up to date, the latter method—the expenditure method—has received more attention in theory and practice than the former—the revenue method. But we think it is extremely important that governments in adapting the management of their fiscal affairs to serve as a contra-cyclical force should be fully alive to the potentialities of both methods and should carefully

weigh their comparative advantages and drawbacks. In practice, the result will probably always be a combination of both methods; but the proportion in which the two are combined is certainly variable, subject to rational change, and adaptable to the particular circumstances and economic and social structure of the country concerned.

The revenue method can be described as follows: with a given rate of government expenditure, *i.e.*, without any increase whatever in government spending, the government can in time of depression exert an influence toward a larger aggregate national expenditure and an increase in employment by collecting less revenue and borrowing the difference between receipts and outlay. This will leave a larger volume of funds in the hands of the public for consumption or private investment and at the same time give employment to otherwise idle savings in meeting government expenditures. These results will be brought about with no change in rates of taxation, provided existing taxes are highly cyclical in their yield. They can also be brought about by a reduction in rates of taxation, or by a remission of taxes. In each of these cases, a larger volume of funds will be left for private spending, which may thus be expected to increase though not necessarily in exact proportion. In each of these cases also, there may be cost effects, which will be registered either in consumer preferences or in investment incentives, depending on the specific taxes involved, their rates and the contra-cyclical measures adopted.

As indicated above, the revenue method already operates, to a certain extent at least, in a more or less automatic fashion depending on the specific tax structure involved, since the yield of most taxes and of other sources of revenue is likely to fluctuate cyclically. This contra-cyclical effect can be magnified by placing increased emphasis within the tax system on levies subject to sharp cyclical fluctuations in yield. Income taxes, provided they are placed on a pay-as-you-go basis, would seem to be well suited for this purpose. It has also been suggested that the rates of certain taxes could be made to vary cyclically on an automatic basis in accordance, for instance, with an index of unemployment or of national income. Were this done, tax rates would automatically fall when unemployment increased by a certain percentage or national income fell. We doubt, however, whether such a system could be

applied automatically in such a way as to avoid *ad hoc* changes; for depressions vary in severity and length, and other relevant circumstances are rarely the same. Finally, certain taxes can be remitted on a completely non-automatic basis in depressions and re-introduced in good years.

There have also been many suggestions in recent years with respect to incentive taxation, that is, the levying of taxes in such a way as to increase the incentive to undertake new investment, to inaugurate improvements, or to maintain working stocks of raw materials or goods in process in times of depression. Among these are the redefinition of business income to permit the offsetting of losses during depression against profits arising in periods of prosperity, more liberal allowances for depreciation, depletion and obsolescence, the last-in first-out method of valuation of stocks, etc.¹ Most of these devices have been advocated in terms of their specific incentive effects, that is, their contra-cyclical influence on investment decisions. They also have an effect, however, on the cyclical yield of the tax system.

The selection of taxes for cyclical variation is an extremely important matter. As we remarked above, a broad personal income tax, collected at the source on a pay-as-you-go basis would seem to be a very powerful instrument for cyclical variations. Taxes are, however, not the only form of public receipts which may be varied with the deliberate intention of contra-cyclically expanding and contracting aggregate public and private expenditure. Thus the British government proposes to vary the weekly contribution paid by employers and employed under its system of social insurance.² Countries which have a general sales tax should consider its suit-

¹ Not all of these suggestions would have the effect of increasing tax payments during periods of activity and decreasing them in periods of depression. When the last-in first-out method of valuation of stocks is used, for instance, it will act to stabilize the rate of earnings of an enterprise as between boom and depression by reducing bookkeeping profits when prices of raw materials are high and reducing bookkeeping losses when their prices are low. This may mean that the enterprise will pay somewhat smaller profits taxes in periods of boom and somewhat greater profits taxes in periods of slump than it would have paid under conventional accounting methods. This tax effect, alone, would not necessarily be a sufficient reason, however, for failing to allow the adoption of the last-in first-out method of valuation in cases where it is justified by wide swings in the prices of raw materials. The stabilizing effect on business decisions of the more accurate method of valuation might well outweigh such differences in tax payments.

² Cmd. 6527, *Employment Policy* (London, May 1944, Ministry of Reconstruction), paragraph 68 on pp. 22-23.

ability for the purpose we have in mind. On the other hand, excise taxes and import duties seem to be less well suited. We do not wish, however, to make specific recommendations concerning this point, because the choice of measures must depend in each country upon the tax system, administrative considerations, the possibility of delegating power to the executive branch of the government to vary tax rates or to remit taxes cyclically, etc. The situation with respect to all these matters is very different in different countries. We should like, however, to list briefly some of the general advantages and disadvantages of the revenue as compared with the expenditure method of contra-cyclical fiscal policy.

The revenue method avoids many of the difficulties with respect to timing and advance planning of specific projects that arise when it is proposed to increase public expenditures in times of depression. It is easier, for instance, at the first sign of depression to reduce revenues than to increase expenditures. Indeed, revenues automatically fall under the revenue method in the case of income taxes on a pay-as-you-go basis and other cyclically sensitive receipts. In the case of the expenditure method, rapidity of execution will necessarily depend on the type of capital projects in contemplation and the degree to which they may be advanced or retarded in accordance with a changing business situation. It would seem probable that in most cases sudden changes in the rate of execution of these projects and the necessity for improvisation would make for waste and inefficiency. The revenue method has the further advantage over the expenditure method that it leaves the decision about how to use "spare" resources—resources that are in danger of going to waste in the form of unemployment—to the public rather than to the authorities. Under the revenue method more scope is allowed for consumers' choice than under the other system.

The revenue method may be less effective than the expenditure method in stimulating national outlay and employment. It is probable that a given deficit, created by a fall in public revenues, public expenditures remaining unchanged, will have a less stimulating effect than a similar deficit created by an increase in public expenditure. The degree to which this is true, if at all, will depend, however, on the type of tax receipts remitted and the type of expenditure contemplated.

A more serious disadvantage of the revenue method is found in the greater difficulty of directing expenditures with precision into a particular part of the economy. This disadvantage is particularly obvious in connection with the construction and capital goods industries, for the effect of tax remission on consumption is greater and more easy to forecast than its effect upon investment. In this respect the expenditure method lends itself to more precise use than the revenue method. We conclude that it would be inadvisable to rely entirely on a policy of cyclical revenue variation to the exclusion of expenditure changes as a method of combatting depression. But we wish to repeat and emphasize our recommendation that the whole problem of fiscal management should be scrutinized from the point of view of stabilizing business activity and that in this scrutiny the potentialities of revenue policies should not be neglected.

5. DOVETAILING PUBLIC WORKS AND THE EXPENDITURE OF PUBLIC ENTERPRISES

We must consider now contra-cyclical public expenditure, particularly that on public works and on public enterprises. The public authorities, when they normally incur large expenditures on account of public works or capital expenditure on account of public enterprises, can contribute greatly to economic stability by timing the inauguration of these operations, holding them back in periods when private investment is high and concentrating them in periods when private investment is low.

The idea that public capital expenditure should be timed in relation to economic fluctuations is of long standing. It found expression in government circulars issued in France towards the close of the nineteenth century, and the Minority Report of the British Poor Law Commission of 1909 urged that the government could "regularize the aggregate demand for labour as between one year and another, by a more deliberate arrangement of its order for work of a capital nature".¹ The first session of the International Labour Conference in 1919 recommended that each member of the International Labour Organisation should co-ordinate the execution of all work undertaken under public authority with a view to reserving such work as far as possible for periods of unemploy-

¹ Parliamentary Papers, *Report of the Royal Commission on the Poor Laws and Relief of Distress*, 1909, p. 1195.

ment.¹ Again, in 1937 the International Labour Conference adopted a recommendation advocating the national planning of public works "so as to reduce economic fluctuations as much as possible", and in 1944 a supplementary Recommendation on the same subject was adopted. In 1938 the Governing Body of the International Labour Organisation, believing that provision should be made for the international co-ordination of public works policies, appointed an International Public Works Committee (now known as the International Development Works Committee). The Delegation has had the advantage at its deliberations of the assistance of a representative of this Committee.

In the absence of any deliberate attempt at stabilization, public capital expenditure has tended in the past to increase when business in general is good and public exchequers full and to fall off in depressions when business is bad and deficits begin to appear.² Thus Diagram XIV (p. 174) shows a steady upward trend in public works expenditure in the United States until 1930, when it receded, accentuating the slump in private capital expenditure which had become acute a year earlier. Had public construction been planned contra-cyclically, as we recommend it should be, a considerable alleviation might have been afforded to the whole industry when private building fell off. Diagram XV (p. 175) suggests that the gross capital expenditure of local authorities in the United Kingdom varies concurrently with business activity as often as inversely.

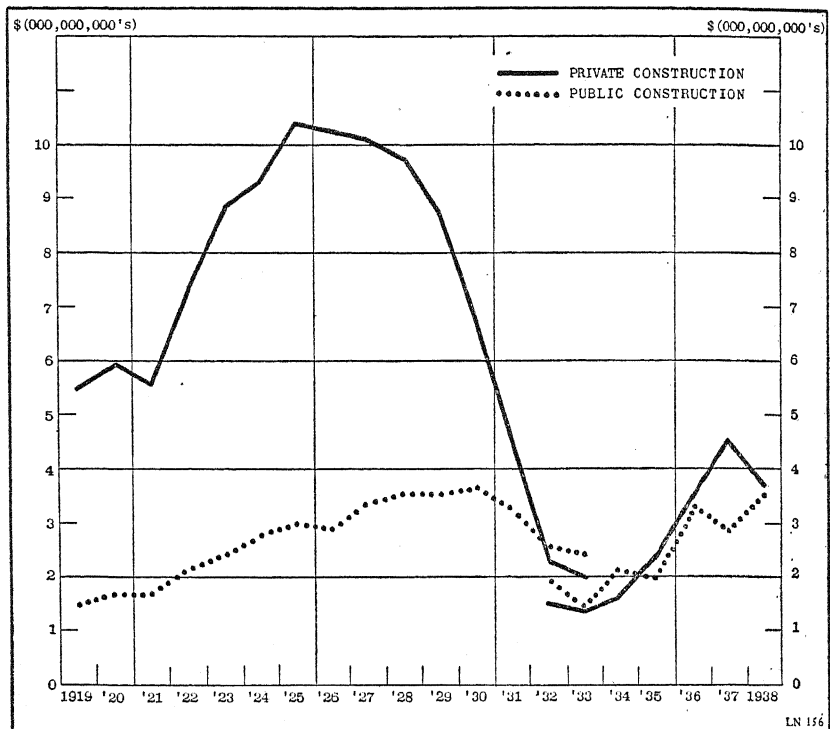
We are glad to note that attempts are now being made in many countries to plan public capital expenditure (state and local) well in advance and to accumulate a "shelf" of fully worked out capital projects which can be put into operation at short notice. This is the right policy and one which we recommend all countries should adopt.

There are, of course, many practical and administrative difficulties in such a policy. It implies central direction or control of the

¹ League of Nations, *International Labour Conference, First Annual Meeting*, October-November, 1919, p. 237.

² A significant exception to this policy was that of Sweden in the 1930's where public capital expenditure was actually doubled between 1932 and 1939. Opinions may differ as to the precise role of this policy in the particularly rapid recovery from the Great Depression achieved in Sweden, owing to the simultaneous influence of a favourable balance of payments situation. But that it was an important contributing factor can hardly be doubted.

DIAGRAM XIV

Public and Private Construction in U.S.A., 1919-38

Source: S. Kuznets, *Commodity Flow and Capital Formation and Supplementary Bulletin No. 74* of the National Bureau of Economic Research.

The public construction figures include maintenance from 1923 to 1933, and the private construction figures include maintenance for public utilities from 1919 to 1933. Both series for the period 1932-38 exclude maintenance.

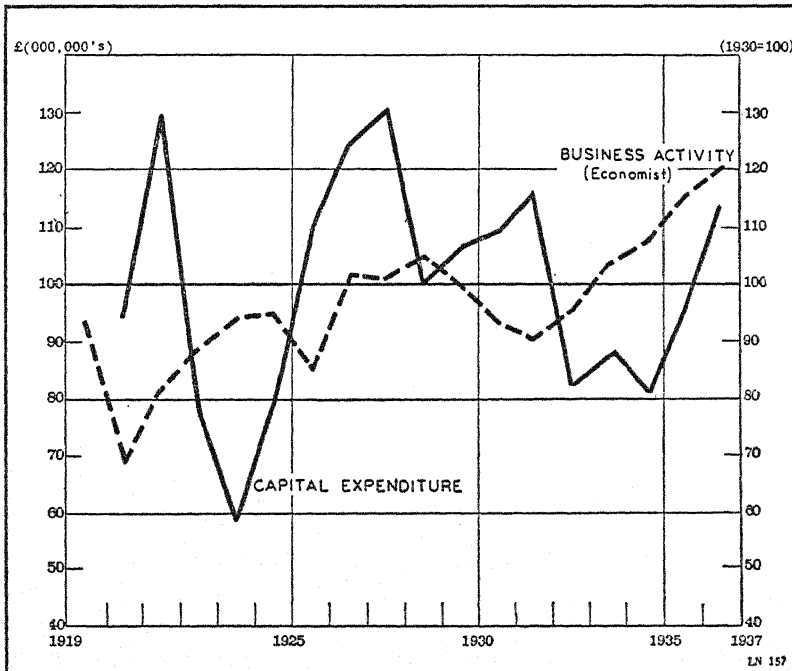
timing of capital expenditure of local and provincial authorities, which in many countries does not exist. There are, moreover, certain capital expenditures which have to be made regardless of business conditions, and there may be strong political pressure against the slowing down of public projects when private activity is recovering. But as we stated in Part I of our Report when discussing government public works:

"It should be the object of the government to dovetail its demand—in fact its public works—into the zig-zag of consumers' demand. In order to do this, it will require to have a general plan carefully elaborated in advance. It should know what it wants to do not next year or the year

after only, but over a period of five or ten years. It should have the individual projects that fit into the general plan worked out in considerable detail; those that are likely to prove the most urgent, for instance, the reconstruction of means of communication or of workmen's dwellings, in as complete detail as the demands of war on personnel permit; it should attempt to classify these projects according to degree of urgency, to the period required for their execution, according to locality, to the type of labour skills required, etc. It should be ready to start on one or another of these projects with the greatest possible promptitude as circumstances demand, and at the same time it should be prepared to postpone putting projects into execution. To achieve this state of preparedness, the closest co-operation between central and local authorities, and, in countries with a federal constitution, between federal and state or provincial authorities, is clearly required. No country can hope to keep business active if central control and singleness of purpose are lacking."¹

DIAGRAM XV

Capital Expenditure of Local Authorities in England and Wales compared with "The Economist" Index of Business Activity, 1919-37



¹ *The Transition from War to Peace Economy* (League of Nations), pp. 62-63.

The effect of a contra-cyclical public works policy will of course vary greatly from country to country. In most countries the expenditure on public works which falls directly on the budgets of the central and local authorities constitutes only a small fraction of national income or indeed of capital expenditure as a whole. It does not constitute, therefore, more than one of a number of instruments of fiscal policy that might be employed. But whenever the railways and other important public services are under state control the influence of the policy we propose applied systematically to all forms of government capital outgoings may be very considerable.

6. INFLUENCE OF DIFFERENT TYPES OF EXPENDITURE

Different types of public expenditure will have different effects on employment. In particular the primary effect on employment will be greater if the money is spent in an industry in which the proportion of wages to total costs is high. It will also be greater if it is spent in an industry or locality in which there are unemployed resources, so that more of the expenditure goes to employing new labour and less to raising wages of those already employed. However, in estimating the primary effects on employment of different types of public expenditure, attention should be given not only to the labour directly employed on the sites of the public works, but also to the new workers employed indirectly, namely in the construction of tools and machinery or in the production of raw materials or semi-finished goods needed for the construction of the public works themselves. The indirect employment caused by public works expenditures will be larger or smaller according to the size of the stocks of raw materials, semi-finished goods and idle machines. The existence of large stocks will mean that a part of the governmental expenditures will fail to raise production and to provide employment immediately because it will be used for purchases from stocks, which will not be replenished until they fall to more normal levels.

The secondary effects of public expenditure on employment are those produced by the additional spending on consumption by the workers employed directly or indirectly on the public works. Their magnitude depends on how much of the additional income is

saved and how much is spent, and on the proportions spent at home and abroad. Attempts at statistical estimation of these secondary effects in various countries suggest that the total increase in employment is usually one and a half times to twice the primary employment created.¹

Some types of public expenditure also have the effect of inducing private investment, especially expenditure designed to facilitate necessary structural adaptation. Thus expenditure on the development of backward areas or urban redevelopment, which paves the way and opens up possibilities for subsequent private investment, will be likely to have a considerable direct effect in promoting investment opportunities, while expenditure on public monuments can at the best only stimulate investment through the indirect multiplier process.¹

Not all types of public expenditure can be conveniently varied at short notice. Thus it would clearly be most undesirable suddenly to cut down expenditure on current services such as education, health, police, etc., which are of great social importance, just because there happened to be a boom in private investment. The kind of public expenditure which could be varied with the least direct disturbance to living standards would be expenditure on those durable goods, roads, buildings, etc., of which current production is a small proportion of the total stock in existence. Moreover, capital projects of this type could more easily be selected so as to provide employment in the localities and occupations affected by the decline in private investment. We have already suggested, for instance, that long-term public housing schemes should be dovetailed as far as possible into the fluctuations in private housing activity.

In the preceding paragraph we have been discussing government expenditure on investment projects. But circumstances may arise which render expenditure on consumption goods desirable. For example, when there is a temporary glut of storable commodities, purchases for stock by the government may maintain continuity of employment and prevent wasteful shifts of productive resources. The opportunities for increasing government ex-

¹ An account of this process (the "multiplier process") is given in *Prosperity and Depression*, by Gottfried Haberler (Third edition, League of Nations, Geneva, 1941, pp. 455 *et seq.*).

penditure on consumption goods as a contra-cyclical measure are, however, limited and preference will therefore in practice have to be given to investment expenditure. Government expenditure is not, of course, always direct. From time to time governments employ public monies to subsidize private business or employ the credit of the state to facilitate borrowing operations by private firms. Such expenditures, when they are justified at all, as they may be for instance when the government is anxious to open up gradually some new area or develop some new industry, should in so far as the primary purpose of such expenditure permits also be made in a contra-cyclical fashion.

In the above discussion of the stabilization of demand through public works we have not assumed any change in the volume of public expenditure over a series of years, but only in its timing. We have assumed that the volume is determined independently on grounds of the inherent value of the projects. To the extent that it is feasible to advance or retard these projects, the stabilization will be effected through variations in the rate of public capital expenditure, any further stabilization that may be necessary being achieved through variations in tax receipts.

7. THE PROBLEM OF ADDITIONAL PUBLIC WORKS

Whether normal public expenditure and revenue will be sufficient to enable fluctuations in private investment to be wholly offset, depends partly on the extent to which that expenditure and revenue can be varied cyclically, partly on the magnitude of the fluctuations in private investment, and partly on the relative importance of public expenditure and private investment in the national economy. It seems probable that the recent trend for public expenditure to assume an increasingly important role in the national expenditure will be continued and even accelerated after the war.

It does not follow, however, that this growth in the importance of the role of government expenditure will enable all governments fully to offset fluctuations in private investment by a contra-cyclical fiscal policy applied to their normal expenditure; and where this is not the case, the desirability of resorting to additional public works has to be considered.

The argument in favour of additional public works is funda-

mentally the same as that in favour of concentrating ordinary public works in periods of depression, namely, that they will increase demand, lead business men to revise their profit expectations favourably and so stimulate private investment.

It is not necessary to contemplate additional public expenditure on a scale sufficient, when taken together with other government expenditure, to compensate for the whole decline in private demand. For public expenditure, through the multiplier processes we have described already, will give rise to additional demand for consumers' and ultimately for investment goods. It should be looked upon therefore as a lever to raise private demand and not as a substitute for it. In particular it is essential that it should not lead to any further shrinkage of private investment by competing directly with it or by raising the rate of interest on private borrowing. At the same time, when such additional public expenditure is undertaken, it must be on a scale sufficient to achieve its primary object of initiating a revival in demand which will lead as rapidly as possible to the re-employment of those who have been thrown out of work.

There should be little difficulty in finding valuable objects for additional public expenditure. Urgent needs for improving the standard of housing, schools, hospitals, communications, public utilities, etc., immediately leap to the mind, and even in the richest countries are likely to persist for a long time. The real problem that presents itself when adopting a policy of additional public expenditure arises not in connection with its immediate execution, but rather on account of its long-run effect, especially as regards the national debt. Let us examine the precise nature of this problem and of the limitations to a successful policy of additional expenditure. We may begin with those limitations which relate to the national debt.

8. LIMITATIONS TO PUBLIC EXPENDITURE

(a) *Debt.*

The long-run effect of national debt will depend in the first instance on whether it is held externally or internally. If it is held externally, important problems of transfer arise, to which reference has been made elsewhere in this Report. But countries are not likely to resort to foreign borrowing to any considerable extent

for the specific purpose of overcoming depression, though, as we shall show in Chapter XIII, contra-cyclical lending is likely to lessen the impact of depression when it occurs or help to obviate it. When the debt is domestic, lender and borrower belong to the same economic community, which greatly facilitates the financing of its service. The money paid by certain individuals in taxes for the debt service remains in the community and is received by other, or possibly the same, individuals in the form of interest. Thus the community as a whole need not be made poorer by the existence of the national debt. Indeed, it can be only owing to the indirect effects of an unwieldy debt to which we refer below. It can, of course, be made poorer by events which give rise to debts, for instance by bomb damage, the cost of which may be paid for by additional public borrowing. But in this case it is the bomb damage, and not public borrowing which is the cause. Similarly wasteful expenditure which has an inflationary influence or which checks profitable investment may render a community poorer than it would have been if that expenditure had not been incurred. But the community can equally be made richer by events giving rise to additions to the public debt, as, for instance, if the money borrowed is used to construct new productive equipment or public amenities, or if deflation is thus prevented. Indeed whenever there is widespread unemployment it is likely to be possible to render the community richer by additions to the public debt. In such circumstances the state, unlike a private individual, automatically increases its income by increasing its expenditure, so long as that expenditure is at home.

We must distinguish, however, between the consequences of incurring additional debt, and the effect of the debt once it is in existence. The effects of incurring the debt depend on the nature and productivity of the expenditure which gives rise to it and the state of employment at the time it is incurred, and possibly, also, on the rate at which the debt is increased. If it is increased very rapidly, it is likely to be financed mainly by the banks, and this may have inflationary effects. When the growth of debt is gradual and can be financed by individual savings, no such inflationary effects are likely to present themselves. But we should add that even a rapid increase of debt, however it is financed, is not likely to prove inflationary when there is large unemployment.

The effect of the debt once it is in existence is quite independent of the reasons which gave rise to it. It is improbable that the financing of the debt will be such as to leave the distribution of income unaffected. If the debt is largely held by richer people, and the tax system is mainly regressive, the financing of the debt leads to a continual redistribution of income from the poor to the rich. This tends to reduce consumption and increase savings with different effects on the level of activity in different circumstances.¹ In a highly dynamic economy where savings are a limiting factor on development, this redistribution of income may facilitate the accumulation of real capital without depressing the level of employment, though at the cost of depressing real wages. In a mature or stagnant economy, if savings tend to exceed investment outlets, it will lead to chronic underspending and unemployment.

At the present time the public debt in most countries is by no means exclusively held by rich people. A growing part is held by small savers, either directly or through financial institutions. At the same time the tax structure of central governments in advanced countries has become more progressive, so that the tendency of the public debt to direct the national income from consumption to savings has diminished, and may even be reversed. When this reverse tendency exists, high taxation of risk capital may check enterprise and lead to unemployment. On the other hand, the stimulus afforded to consumption may help to sustain employment.

The young man entering upon his career with no large accumulation of savings at his disposition will have to bear the full burden of these taxes without benefiting directly from them. His willingness to assume risks may be, and his capacity to make savings will be, reduced.

It is impossible to foresee today what relationship national debt service will bear to national income in any country after this war. In many countries the debt service will constitute an unwieldy proportion of national income involving very real difficulties, especially if prices fall and the real value of fixed money charges are thus increased; in others it may be greatly reduced by inflation; in some of the younger and more progressive countries it

¹ Cf. Alvin Hansen, *Fiscal Policy and the Business Cycle*, pp. 152-7.

may not assume proportions that involve any serious internal transfer problems. But the problem of debt requires to be considered also in connection with the demographic pattern of society. In most countries of western civilization populations are ageing and ceasing to grow and are likely in the foreseeable future to decline. A decline in population will make the problem of debt much more serious, as the productive section of the community diminishes and the dependent section grows. For as the British White Paper to which we have already referred observes, "owing to the prolonged decline in the birth rate and the present age distribution of the population we can no longer rely, as in the past, on an increase in national income resulting from an increase in the number of income-earning persons".¹ On the other hand, productive processes are constantly becoming more efficient. Through discoveries and new inventions and the improved organization of agriculture and manufacture, productivity has steadily increased in the past and is likely to continue to increase in the future. With this greater productivity the national income and the income per head of population will rise, and the burden of the debt will be proportionately diminished.

(b) *Effect on Private Enterprise.*

It must be emphasized, however, that an increase in the public debt should not be the only, or even the primary, means of counteracting a deficiency in expenditure. Simultaneous measures to raise the level of private investment (including investment by public corporations) together with structural measures designed to increase consumption and decrease savings should reduce the need for increasing public loan expenditure of a kind which does not yield a direct financial return sufficient to cover the outlay. This type of public loan expenditure should be employed only in so far as the objects of expenditure are in themselves socially desirable and kept within limits which could be financed without any harmful increase in tax rates.

Other limitations to the efficacy of fiscal measures as anti-depression devices are of very different orders of importance. We may consider first one which is closely connected with that of the growth of debt, namely, the possible adverse effects of deficit financing on

¹ Cmd. 6527, *Employment Policy*, p. 25, paragraph 78.

business enterprise. These adverse effects may be due either to unfounded mistrust of the policy of government spending or to real impediments to business caused by that spending. Neither the one nor the other can be ignored. If the government spends in order to make good a lack of private investment, and that spending leads to a further contraction of investment, clearly the policy is defeating its own ends. The problem here is not one of finance but of understanding. It is of the utmost practical importance that the simple fact should be understood that the community will benefit if the government makes use of surplus productive capacity resulting from general underspending, and that all should co-operate to revive business when it is slack and maintain it on an even keel.

(c) *Effect on Capital Markets.*

The more permanent impediments to successful enterprise that may be caused by large-scale government spending are consequential increases (or stickiness) of interest rates and of wages. When the purpose of government spending is to overcome a situation of excessive liquidity, the risk of its giving rise to deterrent interest rates is obviously not likely to present itself as a general rule, unless the government continues its spending for too long. Nor is it likely to arise in the richer industrial states in which capital is abundant and the government credit stands high. These impediments will not exist, consequently, in the more highly industrialized countries which are in a position to exercise the most powerful influence in averting depression, provided the spending is properly timed to coincide with the existence of unemployment and unused resources. They may arise, however, if the financial mechanism is seriously disorganized; if the government's credit is not of high standing; if the country in question is not well endowed with capital resources so that any temporary excess of savings is very rapidly absorbed; or if the capital market is badly organized; and more especially if fear of the government's intervention should lead to capital export. In such circumstances the application of contra-cyclical fiscal policies should be made part of a more comprehensive programme designed to repair defects in the financial mechanism and prevent difficulties in the balance of payments. There is sometimes, also, a risk in these countries that the govern-

ment may be unable to place its bonds readily with the public or the commercial banks. This situation must be dealt with directly so that the government is not forced, by reason of recourse to the central bank, to destroy that institution's control over the money market by freezing too large a proportion of its assets in unsalable government paper.

In the development of all contra-cyclical policies it is important that the central banks remain in a position to develop appropriate monetary policies including the conduct of open-market operations. We have to accept the fact that in the poorer countries with less highly developed money markets the power of governments to revive business through fiscal measures is probably more limited than it is in the highly industrialized and richer states. In these poorer countries, however, fluctuations in private investment do not play so important a role in determining economic activity. In all countries government borrowings to revive business should be combined with monetary and credit policies as effective as the local conditions permit aiming at reducing the interest rates or maintaining cheap money.

(d) Effect on Costs.

If the effect of government spending is to prevent an all-round reduction in wages, this will, for reasons we have already given, prove beneficial rather than detrimental to business. But it is important that such spending should not prevent necessary cost reductions from being effected and so impair the profitability of industry. If, for example, building wages are high in relation to current incomes and rent levels, public construction projects must not be allowed to keep them rigid at an uneconomically high level and so hinder private building. Similarly, increased public demand for materials should not prevent price adjustments which would benefit private industry from taking place.

(e) Inflationary Influences.

The fear of inflation has frequently been a serious hindrance to a vigorous programme of public expenditures and fiscal policy in depressions. In several countries it has either prevented policies such as those proposed in the preceding pages or reduced them to an ineffective and insufficient level.

The danger of inflationary price rises resulting from an increase in aggregate expenditure when carried out through appropriate financial measures is slight or non-existent so long as general depression conditions, that is, widespread unemployment, prevail. The real danger of inflation comes at a later stage when a high level of employment has been reached in many industries and areas, and output cannot be quickly expanded. But the transition from a general depression to full employment is gradual, and full capacity production is reached in some branches of industry and in some localities while depression still lingers in others. For these reasons inflationary price rises are liable to occur long before anything like literal full employment throughout the economy has been reached. We propose to discuss this problem of inflation more fully in Chapter XIV and will not therefore further elaborate these points here.

9. NATIONAL INCOME BUDGET

We drew attention in Chapter VII to the fact that the acceptance by governments of the obligation to endeavour to maintain a high and stable level of employment implied the substitution of a broad economic approach to the budget for a purely financial approach. By this we mean that they should think, not in terms of government outgoings and revenue only, but in terms of total national outlay and total national productive resources. In order to afford a factual basis for their policies, governments should, therefore, in our opinion, supplement their annual budget estimates by estimates of national income and expenditure. These estimates should be prepared in sufficient detail to constitute a real aid to governments in diagnosing the situation and determining what type of policy is required in order to maintain national income as close as possible to capacity output. They should, moreover, when conditions permit, be prepared in the first instance for a series of past years and then continued year by year, so as to make it possible to trace the course of developments and thus facilitate the task of contra-cyclical budgeting.

As we have already remarked, statements of this character have been furnished for several years in the United Kingdom during the course of the present war.¹ These statements have been pre-

¹ For example, Cmd. 6520, *op. cit.*

pared for purposes of war finances and would no doubt be slightly different in peace time. Each country will naturally require to analyze and group its data in such a way as best to facilitate diagnosis of its own position. But it is important that the statements should at the same time be internationally comparable.

Sir William Beveridge in his book entitled "Full Employment in a Free Society",¹ which has appeared during the course of our sessions, gives the following broad classification of national outlay, which we reproduce for purposes of illustration:

- | | |
|--|-----|
| 1. Private Consumption Outlay | ... |
| 2. Net Private Home Investment Outlay | ... |
| 3. Balance of Payments Abroad | ... |
| 4. Public Outlay on Goods and Services from Revenue | ... |
| 5. Public Outlay on Goods and Services from Loans | ... |
| 6. Unused Resources | ... |
| 7. Output Capacity (items 1 to 6) | ... |
| 8. Total Public Outlay on Goods and Services (4 + 5) | ... |

This grouping, apart from the item "Unused Resources" and minor terminological differences, is the same as that which we have employed throughout the analysis contained in this Report. If the calculation is made for the forthcoming year, the item "Unused Resources" represents the difference between (a) output capacity, that is, the national income which would be attained assuming that level of employment which is accepted as the theoretical maximum, and (b) the national income actually estimated for the forthcoming year. The object of government policy should be to reduce this final figure, "Unused Resources," to zero. As we have already remarked, this result may be achieved by raising any one of the other items (1 to 5, above).

Governments should, in our opinion, explain when submitting their annual budget, together with the National Income Budget, to their parliaments what measures they have taken or contemplate taking in order to bring about this result. In this manner the legislature and the general public will be kept informed of the nature and purposes of government policies and of the government's estimate of prospective business conditions.

¹ Sir William H. Beveridge, *Full Employment in a Free Society*, p. 139, George Allen and Unwin, Ltd., 1944.

In addition to constituting a general aid to diagnosis, this procedure should greatly help governments in contra-cyclical budgeting, for the estimates made of current and future business conditions, if carefully elaborated, and especially, perhaps, if supplemented by certain monthly figures reflecting the trend of events, will enable them to frame a judgment regarding the phase of the business cycle that has been reached and regarding, therefore, the need for expanding or contracting government expenditure.

We should add, perhaps, that we do not believe that governments will be able year in and year out to keep the item "Unused Resources" in their balance sheet down to zero. The productive mechanism is too complex and too rigid to permit of this result being attained automatically and immediately by fiscal or other methods. We explain in Chapter XVIII the particular difficulties likely to face agricultural and mining countries. In industrial states, also, some interval is likely to elapse before the most carefully elaborated plans can become completely effective. Demand may shift to goods and services for which the existing equipment and labour skills are ill adapted; foreign demand may shift from one market to another. Retooling and retraining may be necessary, and during that period some existing resources will be unemployed. Nor does the fact that by one means or another jobs are found for workers thrown out of employment necessarily imply that the national income is maintained. The productivity of these workers in their new employment may be lower than it had been previously. But these considerations in no way diminish the need for a clear annual statement of the national income position and of the policy proposed for maintaining that income. That policy may relate to government outlay or to private outlay, to domestic or to government expenditure. It will vary according to the conditions obtaining on any particular occasion; it will vary from country to country. As the French Comité National d'Etudes stated in its report¹ on post-war economic policy, when discussing the maintenance of economic activity: "les difficultés d'une telle politique résident moins dans le choix des moyens à employer que dans la détermination à chaque instant du diagnostique de la

¹ René Contin, *Rapport sur la Politique Economique d'après-guerre*, "Editions Combat", Alger (Algiers), 1944.

situation. Il est malaisé de prendre les dispositions au moment opportun et plus encore de doser l'importance qu'il convient de donner à chaque mesure."¹

10. GENERAL CONCLUSIONS CONCERNING FISCAL MEASURES

We have made the foregoing reflections concerning government spending and public debt, inflation, etc., because of the importance we attach to governments watching with care the secondary effects of any compensatory policies they may find it necessary to pursue. We do not wish to be interpreted, however, as expressing any doubt that in the event of a serious falling off in private demand such compensatory policies may be necessary. When, owing to the threat of serious unemployment which is not of a local or structural character, it is felt that compensatory policies are necessary, they should be undertaken with promptitude and courage. They should, however, at the same time be undertaken with due attention to the various points we have just mentioned. What is required is a judicious and persistent determination—a determination to employ this and all the other means available to overcome depression; not a simple belief that government spending alone is likely at once to revive business and establish stable economic conditions. Government spending is one and a very important weapon in the whole armoury that may be employed in the fight against depressions and unemployment.

¹ *Translation:* The difficulties of such a policy lie less in the choice of the means to employ than in the diagnosis of the situation at each moment. It is not easy to take the necessary measures at the right moment and still less to determine the exact degree of importance to be attached to each measure.

CHAPTER XIII

FOREIGN INVESTMENT

1. THE IMPORTANCE OF CAPITAL EXPORTS

The level of employment in any country is affected not only by domestic expenditure on investment or consumption but also by changes in the foreign balance, that is, in the excess of exports of goods and services over imports. An increase in exports in any country will raise the level of employment, if domestic expenditure as a whole remains unchanged. A decrease in imports under the conditions posed may have the same immediate result if there is a shift from foreign to domestic commodities, though its ultimate effect, owing to the depressing influence of the reduction in the exports of other countries that it causes, may be to reduce employment all round.

As explained in Chapter VII, this method of increasing employment differs from those depending on domestic expenditure, because of its effects on other countries. Whereas an increase in employment due to domestic investment renders the balance of payments of other countries more positive and stimulates employment in these countries, an increase due to an export surplus may have precisely the opposite effect. This does not mean, however, that an export surplus on current account is necessarily harmful to other countries. On the contrary, if it permits of additional investment in those countries, it may be extremely beneficial. This is particularly true of under-developed countries which wish to develop their resources; for such countries are likely to have a deficiency rather than an excess of savings in relation to investment opportunities. In this situation an import surplus on current account is to be welcomed as relieving poverty and accelerating development, rather than feared as a source of unemployment. But an import surplus has to be paid for, and as gold and foreign exchange reserves are usually very limited in under-developed countries, it can only be maintained by capital imports.

Foreign lending allows the lender to maintain an export surplus which helps to offset excess savings and stimulate employment, and the corresponding import surplus in the borrowing country enables resources to be developed more rapidly or with less sacri-

fice of current living standards. We have already drawn attention in Chapter X to the importance that foreign lending might have as an anti-depression measure were it possible to stimulate it when economic activity in the highly industrialized countries slackened. An increase in the exports of capital goods by these countries when their own domestic demand for such goods is temporarily satisfied constitutes indeed the most direct and satisfactory method of maintaining employment and preventing a depression from spreading from the mechanical and heavy industries throughout the whole economy. By this means plants could be kept running, labour shifts would be avoided and the importers of these capital goods should be able to acquire them at favourable prices owing to the slackness of demand for them in the producing countries. Moreover, if by this means employment is maintained in the producing countries, the demand of these countries for crude products from the rest of the world would remain active and the threatened depression would spread neither internally nor overseas.

Unfortunately, capital exports have not taken this contra-cyclical form in the past, but, on the contrary, have tended to expand as business improved (though not always during the culmination of a boom) and to slump or be reversed when or shortly before general business conditions deteriorated. Foreign investment, in consequence, however beneficial its long-term effects, has tended rather to accentuate than to soften industrial fluctuations.

2. THE IMPORTANCE OF THE FORM OF CAPITAL EXPORTS

This intensification of industrial fluctuations and of their incidental depressions has been all the greater because so large a proportion of capital exports has taken the form of fixed interest-bearing loans with rigid amortization provisions. In consequence the borrowing countries have found themselves faced during depressions with a contraction in their export markets, a serious fall in the prices of their export commodities, a cessation of receipts of foreign currencies on capital account, and the obligation to meet unchanged money charges in foreign currencies on account of debt service. On some occasions their position has been rendered all the more difficult owing to the fact that too large a proportion of their capital imports took the form of short-term loans which were not renewed so that the flow of capital was actually reversed

at the very moment that their resources were the most depleted. This happened during the great depression of the 'thirties, and the strain imposed on the foreign exchanges of the debtor states contributed materially to the breakdown of trade and the widespread collapse of the whole system of international economic relations which had been so painfully built up in the first post-war decade. It led, moreover, to a mistrust in foreign lending which, if continued, would augur ill for the future.

A mistrust in foreign lending would augur ill for the future for a variety of reasons. In the first place, the enormous discrepancies between living standards in the rich industrialized countries and the under-developed parts of the world, which are heavily populated but deficient in capital equipment, will inevitably create political stresses and strains of a dangerous character. In the nineteenth century this pressure was relieved to some extent by mass migration from the poorer to the richer countries. The virtual closing of this safety valve creates an explosive situation which can only be met if the richer countries are prepared to assist in raising the standards of living of the poorer by helping in their industrialization.

The process of industrialization of the under-developed countries will, in our view, take place with or without assistance from outside in the form of foreign lending. In default of outside assistance the process will take longer and it will necessarily be accomplished through depressing at first the already low living standards of the under-developed countries. Moreover, if no outside assistance is forthcoming, it is likely that many of the economically under-developed countries will aim at producing at home the industrial equipment of all types they require for their industrialization, with consequent adverse effects on the flow of international trade and the loss of benefits of the international division of labour. On the other hand, if the economic development of economically under-developed areas is assisted by foreign investment, it can proceed more quickly and with smaller risk of fostering autarkic tendencies inimical to the healthy development of a world economic system.

From the point of view of the lending countries, the contribution to peace and political stability is by no means the only return derived from such lending. It provides, initially, an outlet for

savings which might otherwise be allowed to go to waste in the capital-exporting country, and ultimately, by raising the standard of living of the capital-importing country it provides the basis of a flourishing and lasting trade.

Foreign investment is, in our view, so important an instrument, if properly employed, not only for improving conditions in under-developed areas but also for diminishing the risks of depression in highly developed countries, that ways and means must be found to overcome the dangers to which it may, if unwisely conducted, give rise. The first essential is to prevent the haphazard changes in the flow of foreign investment which exercised so unstabilizing an influence, both in the lending and borrowing countries, in the inter-war years. General stability of income is the primary condition for stability in international lending. If this is not achieved, we believe, for the reasons given later in this chapter, that a deliberate attempt should be made, by the capital exporting countries and by international institutions concerned with long-term foreign lending, to concentrate the bulk of such lending in periods when industrial activity is low in the surplus countries.

A number of problems of major importance thus arise for consideration. How can willingness to invest be revived? By what method of foreign lending or investment can the strains on transfer capacity imposed by the weight of foreign debt be best mitigated? How can the economic and profitable employment of foreign capital received best be assured? How can foreign investment be so directed as to take a contra-cyclical rather than a cyclical pattern?

3. THE PREREQUISITES OF FOREIGN INVESTMENT

We cannot hope within the compass of our Report to enter at all fully into these questions or the large number of subsidiary questions which they imply. Moreover, we are not concerned here with the immediate post-war period during which the reluctance to lend abroad may manifest itself. Proposals have been put forward at the recent Bretton Woods Conference for the establishment of an International Bank for Reconstruction and Development which, with the aid of joint government guarantees, may, it is hoped, overcome that reluctance and provide the machinery

necessary to meet the special risks, real or imaginary, of foreign investment. We are concerned with the long-term problem of economic fluctuations and unemployment. This long-term problem can only be solved in a world in which international co-operation exists and the necessary instruments for the conduct of international affairs have been created. The two major deterrents to foreign lending in the decade immediately preceding the outbreak of the present war were fear of international conflict and fear of economic depression and of the transfer difficulties to which depressions give rise. We do not believe that depressions can be avoided or mitigated in the absence of effective machinery for assuring political security and for facilitating economic international co-operation. We must assume, therefore, in this Report that such machinery exists, that at least all the states enjoying a free price economy constitute a common trading system and are parties to a common monetary system or closely interlinked systems.

4. THE MEANS FOR MITIGATING THE STRAIN OF FOREIGN DEBT

In Chapter XX we put forward proposals regarding a Central International Body charged with the duty of promoting the co-ordination of national policies for the maintenance of the fullest possible measure of employment. We do not propose to discuss now this international machinery or the monetary and trading system of the future. But we take it as axiomatic that in the long run debtors will only be able to transfer the service of their loans to the extent that creditors are prepared to accept payment in goods and services, and that, unless creditors pursue a commercial policy which permits of a large volume of international trade, default is likely sooner or later to occur. Our concern in this chapter is to formulate certain broad principles concerning foreign lending, which we believe will be conducive to a smoothly working economic system, postulating that the necessary mechanism exists.

Let us consider first how the strain that the obligation to transfer the service of debts contracted in the past may impose on a country's economy can best be mitigated or avoided. The first essential is that foreign lending should increase the productive capacity of the borrower in such a way as to make the transfer of

the service possible. But even when loans contracted are rigorously confined to purposes which give rise to this increase in transfer capacity, the borrowing country may be faced with serious difficulties in periods of depression when the price of its export products fall and its transfer capacity is reduced far below normal. Moreover, it is extremely difficult to assume that any investment, whether made with domestic or foreign capital, will render a return indefinitely. For these reasons we have suggested that the export of capital in the form of equity or direct investments is preferable to foreign loans, since the yield of such investments will tend to vary with the general prosperity of the receiving country and therefore with its power to transfer.¹

To what extent equity lending will be revived is, however, impossible to foresee, and it is desirable in any case to render foreign bonded debt as adaptable to fluctuations in economic conditions as possible. Some elasticity might be afforded by providing in the loan contracts for accelerated amortization in periods of activity, which would permit of relaxation of amortization when transfer difficulties arose without affecting the rate of amortization over the whole period of the loan. It is interesting to note in this connection that the draft statutes of the International Bank for Reconstruction and Development permit the Bank at its discretion to "make arrangements with the member concerned to accept service payments on the loan in the member's currency for periods not to exceed three years upon appropriate terms regarding the use of currency and the maintenance of its foreign exchange value, and for the repurchase of such currency on appropriate terms".

Such elasticity as this clause affords is, of course, facilitated by the fact that for the loans to which it applies the Bank itself is the sole lender. In the case of loans concluded between a single borrower, for instance a state, municipality or firm, and an unascertainable number of anonymous owners of bearer bonds, the borrower is forced into default whenever it is unable for one reason or another to continue to remit the full service of the loan. It might be well to make prior provision in loan contracts for trustees elected by the majority of the bondholders to act for all in the case of default, which would at least prevent the long-drawn-

¹ *The Transition from War to Peace Economy* (League of Nations), p. 95.

out delays which may be caused at present by a small minority of bondholders reluctant to accept an arrangement. When transfer difficulties are so serious that some relaxation of service obligations is unavoidable, it is clearly desirable that an understanding should be reached between debtor and creditor of a formal character.

The strain to which a loan may give rise is determined not by the amount of the loan, but by the amount of its service, which is determined also by its length, which fixes the amortization rate, and by the rate of interest. The period for which lenders will be willing to lend will be greatly influenced by the prospects of political security, the prime importance of which is obvious. The rate of interest in the past has been determined on the one hand by general market conditions in the capital-exporting countries and on the other by the credit standing of the borrowing country. This under free market conditions is inevitable, but it leads to the result that the greater the risk, that is, the weaker the borrower's position, the greater is the strain that will be imposed on it by a loan of any given amount. No doubt this circumstance tends to check overborrowing, but it tends also to augment the probability of default and to retard the development of relatively under-developed areas. When the rate of interest at which any country can borrow is so high that the risk of default is clearly increased, no attempt should be made to issue a loan through the normal market mechanism. What is required in such circumstances is some form of intergovernmental long-term credit institution such as the proposed International Bank for Reconstruction and Development, which could guarantee loans intended for really constructive purposes. It is not our intention to enter into the complex question of joint and several guarantees; but we believe that both for the purpose of securing reasonably low rates of interest and, as we shall indicate shortly, in order to promote contra-cyclical foreign lending, some such organ is indispensable.

5. THE PROFITABLE EMPLOYMENT OF FOREIGN CAPITAL

The second question that arises for consideration is how the profitable investment of capital imported from abroad can be assured and waste obviated.

The most obvious means of assuring that capital imports are

spent on capital goods likely to raise the productive and the transfer capacity of the importing country is to link the loans contracted directly to the purchase of such goods. By this we do not mean that the goods should necessarily be purchased in the country in which the loans are raised. On the contrary, it is obviously desirable that the borrower should be able to purchase in the cheapest market.

We have to recognize the fact, however, that occasions may arise in which a government or, indeed, a municipality, or, for instance, a port authority, may wish to borrow abroad for some project which does not necessitate the import of any large amount of capital goods from abroad. Such a loan may greatly increase the productive and transfer capacity of the borrowing country. Thus a government may require help in constructing trunk roads or a port authority in deepening a harbour, on which the major cost is for local labour. The foreign capital, which in such a case is not employed or is only partly employed for the acquisition of foreign capital goods, can only prove of use by helping the borrowing country to obtain goods required for current consumption that cannot be produced at home because the labour and other resources that would be needed to produce them are engaged on this particular project. But the borrowing government or other body will not normally purchase these consumption goods directly abroad itself. It will on the contrary sell the proceeds of the loan to the central bank against domestic currency and utilize the domestic currency received to meet wages and other domestic expenditure. The reserve of the national bank will thus be increased and against that increase a general expansion of credit may be effected. These operations thus involve obvious dangers. For in the circumstances described it is extremely difficult to guarantee that the borrowed monies will be expended abroad on the necessities that the domestic labour, owing to its new occupation, is unable to produce and not on luxuries for which the additional purchasing power resulting from the loan may create a demand. It would, in our opinion, however, be unreasonable to prevent all such operations on account of these dangers. But it is necessary to find means to control their inflationary effects.

The most effective means in our opinion is to arrange that part of the capital required for the project is raised at home. For the

participation of the nationals of the borrowing country would absorb some of the increase in the funds in the market resulting from the foreign loan. On this participation the foreign lender can always insist. Apart from this it lies within the competence of the government of the borrowing country itself to make provision against waste by appropriate administrative and fiscal measures.

Equity capital and direct investments, employed as they are for a specific purpose, are more likely to be used productively than monies borrowed by governments and public institutions against bond issues. The danger of waste arises mainly in connection with certain classes of foreign loans, whether these are long- or short-term and whether they are contracted by governments, other public bodies, or by private concerns. To avoid this danger it is necessary in the first place that governments should realize that foreign lending and borrowing exercise an extremely important influence, both immediately when the loan is raised, and subsequently when service exceeds capital receipts, in checking or in spreading, in alleviating or in deepening, depressions. They constitute a major subject of policy, and governments and monetary authorities of both borrowing and lending countries should take steps to keep themselves constantly informed of the character and volume of all foreign commitments so that they may be in a position to foresee difficulties before they arise and take appropriate steps to deal with them.

In this connection it must be borne in mind that in a closely integrated world fluctuations in economic activity spread rapidly from country to country and require to be watched, not only nationally but internationally. It is therefore of equal importance that governments, as regards long-term loans, and the national monetary authorities, as regards short-term operations, should keep in the closest possible touch with whatever international organs may be set up to advise on anti-depression and monetary policies. Individual governments should satisfy themselves that the monies received are so expended as to afford a good prospect that they will directly or indirectly increase the productive capacity and hence the transfer capacity of the country by at least the amount required to meet the service of the debt. In addition, whatever international body is concerned with anti-depression policy should watch the cyclical effects of international lending.

By this we do not mean that such operations should be submitted to it for approval, but that it should be entitled to give advice and recommend guiding principles of policy and also warn governments, if occasion arises, of any dangers that may present themselves.

6. CONTRA-CYCLICAL FOREIGN INVESTMENT

Up to this point we have been concerned with the negative issues of avoiding the strains imposed by foreign debt service and preventing the wasteful use of funds borrowed abroad. There remains the positive issue of endeavouring to bring about a contra-cyclical international flow of capital. This, as we have already emphasized, would benefit lender and borrower alike, for it would prevent the savings of the former from going to waste and unemployment from developing, and it would prevent a strain on the exchanges of the latter from developing and, indirectly, owing to its influence on employment in the lending countries, sustain the demand for the products of agricultural and mining areas.

While we are quite clear that contra-cyclical lending is the proper objective of policy, we have no illusions about the difficulty of securing it. What measures to this end are in fact practicable?

The behaviour of short-term credit will obviously be very largely determined by the nature of the international monetary system set up after the present war. But it is an accepted principle of the proposals now under discussion¹ that a primary purpose of any system must be to relieve temporary strains on the exchanges of all countries, and, in so far as the reserves owned by any country are inadequate for this purpose, resort must be had to credit operations. Since in practice it is the exchanges of the producers of crude products that are subject to the greatest strain during slack times, this principle implies the contra-cyclical use of short-term credit.

When in addition governments assist their export trade by some export credit system they could facilitate the task of the monetary authorities and help their own industries by granting more favourable terms during bad times and tightening those terms when trade is booming. The producers of capital goods them-

¹ See in this connection the proposals of the Bretton Woods Conference.

selves may be more willing to grant favourable credit terms to foreign purchasers when their business is slack, irrespective of any governmental assistance they may obtain, if they know that this is in accordance with approved policy and has the support of the banking and monetary authorities. But any such policy is dependent for its success on the willingness of countries or firms to purchase capital goods against credit at times when business prospects are dark. That it will probably pay them to purchase at lower prices and in time to be ready for full production when demand expands again may not of itself prove a sufficient incentive, for economic fluctuations are accompanied by similar fluctuations in business sentiment. The governments of the borrowing countries may be able to facilitate such operations by reducing import duties when they exist or by other means. We draw attention in Chapter XIX to the plans which have been under discussion for the establishment of international buffer stocks of crude products. The operation of such a scheme, if stocks tended, as is to be expected, to increase when business was slack and to fall off when activity revived, and if they were financed largely by importing countries, would have an influence similar to contra-cyclical short-term lending.

It is likely to prove more difficult to promote contra-cyclical long-term lending. Investment falls off during slack times not only because attractive openings are reduced, but also because the sentiment of the market is in favour of liquidity. This liquidity preference is likely to prove even stronger regarding less familiar foreign ventures than it is regarding openings at home. Companies are therefore not likely either to wish or to be able to sell their shares on foreign markets, and large firms in creditor countries are not likely to open branches or start affiliates abroad when business conditions are inactive.

A contra-cyclical movement of long-term capital exports could, however, be promoted through public or semi-public investment bodies, such, for instance, as the proposed International Bank for Reconstruction and Development, or an international Agricultural Credit Bank. Bodies of this sort must necessarily pursue a long-term policy. One of their main objects must be to raise the general productive capacity of the countries in which investments are made so as to strengthen their trading and transfer

powers. The profit from the investments made may often be rather indirect than direct. Thus, for instance, a Development Bank may loan funds to build dams and electrical generation stations and be more interested in the gain to the country from the power rendered available than in the profit earned by the utility itself. However this may be, it is concerned rather with the general development over a considerable series of years than with immediate returns. It is clearly to the advantage of all parties in such circumstances to effect the necessary capitalization at the lowest possible cost, to borrow when money is cheap and to purchase the required equipment when prices are relatively low—to pursue, that is, a policy of contra-cyclical capital export. That is the policy which we hope will be pursued. But as we have said earlier in this report, the pursuit of this general policy must not be allowed to cause an interruption of work already initiated on projects which require several years for their completion.

CHAPTER XIV

EMPLOYMENT AND INFLATION

1. THE DANGER OF INFLATION

We drew attention in Chapter XII and in earlier chapters to the danger of a policy of government spending having inflationary effects and showed that the inflationary process might begin before full employment was reached. In fact any policy aiming at a high level of employment involves the risk of inflation and this risk constitutes one of the greatest difficulties in formulating and applying a sound anti-depression policy. We propose therefore to devote this chapter to a further consideration of certain aspects of this general problem of economic stability and inflation.

We are not concerned here with the violent currency inflation which occurred after the first world war and is occurring in some countries today. The causes of inflation of this type are in no way connected with the ups and downs of the business cycle, and we consider this phenomenon as wholly outside our terms of reference. What we have in mind is a tendency towards steadily rising prices so persistent as to threaten economic stability, but not so violent and dramatic as to undermine confidence in money as a medium of payment or as a standard of value.

One of the major beneficial results of any policy for securing fuller employment is to bring about a rise in total wage payments. But there is a danger, if the situation is not carefully watched, that at an earlier or later stage in the execution of such a policy, rising wage rates may set in motion a cumulative inflationary process. The danger presents itself in its most acute form when there is booming trade, when the demand for labour tends to exceed available supplies and to lead to wage increases that are not offset by equivalent increases in production.

This tendency for wage rates, and consequently costs and prices, to rise may appear quite soon in particular localities or industries if labour is in short supply. Thus, as we have already observed, inflationary tendencies are likely to arise before full human employment has been reached in the economy as a whole, just as they are likely to arise before full employment of all the available land, machinery and other factors of production has been reached. It is

a common and misleading practice to speak of labour as if it were a uniform productive force like hydraulic power. In fact it is not, but consists of aggregates of skills and experience, any one of which may be in short supply while others are partially or wholly unemployed. Labour cannot be shifted at will from one occupation to another. It can, no doubt, be trained to new skills, just as many machines can be retooled to produce different goods. But in most cases this adaptation takes time and before it has been effected an increased demand may have led to price distortions and have initiated an inflationary process. The danger that a shortage of particular types of labour will lead to inflationary price rises is, however, considerably greater than the danger that a shortage of particular types of machinery will do so. We wish to emphasize the points that labour is not uniform or fluid, that in consequence shortages are likely to arise before full employment is reached, and therefore that all measures tending to render labour more fluid—more easily transferable from one job to another—will diminish the risk of inflation. Transfer of labour will be facilitated if there is some reserve of machinery and other tools of production so that an increased demand for any product is not impeded by lack of equipment.

The tendency for wage rates to rise in consequence of shortages of labour in particular areas or industries, and of trade union demands, will not, however, be the only source of pressure on costs and prices. Sectional interests, as for instance the farmers, may, if they are highly organized, try to obtain special benefits for themselves in the form of increased prices before a high level of employment all round has been reached. Similarly monopolistic groups which are sufficiently powerful to control prices in their respective industries, will, if they raise prices in the early stages of the revival, contribute to the inflationary danger.

Before turning to the implications of these facts as regards policy we should perhaps set out briefly our reasons, some of which we have already mentioned in earlier chapters, for attaching so much importance to the danger of inflation.

Our first and most important reason is that inflation is likely itself to breed depression and therefore to jeopardize the prime object of the policy we are discussing. It is likely to cause depression for several distinct, though interrelated, reasons.

(i) When prices are pressed constantly upward by inflationary processes, anticipatory purchases of materials are likely to afford an automatic profit which inevitably gives rise to speculative purchases and accumulation of stocks of goods. But sooner or later such speculative transactions must break down; demand by consumers will be adversely affected by rising prices; the accumulating stocks threaten the market and with the first failure of prices to continue their upward trend profits disappear, while the costs of holding stocks pile up. This will lead to a liquidation of stocks with a consequential fall in prices, shrinkage in demand, and contraction of output.

(ii) A constant rise in prices tends to change the distribution of income away from all persons with fixed money incomes, or from persons whose incomes change relatively slowly, in favour of owners of equities. It causes therefore a direct loss to all rentiers, owners of bonds, savings deposits, etc., a less absolute but still real loss to those classes of wage earners whose wages have not contributed to this inflationary process and a gain for a time to those whose income is derived mainly from profits. The purchasing power of what is normally the most stable element in the market, the small rentier, and of the scarcely less stable and vastly more important element, the wage or salary earner, thus tends to be reduced, and sooner or later consumers' demand falls off; profits and savings increase for a time, but with the reduction in consumers' demand savers find diminishing investment opportunities.

(iii) The incentive to invest may further be diminished by the higher rates of interest to which inflation may give rise.

(iv) If the general level of prices rises faster in one country than elsewhere, that country will suffer a deterioration of its balance of payments and a drain on its gold and foreign exchange reserve. It will be forced to check the inflationary process and expedite the depression which for the reasons we have given would be likely to occur sooner or later in any case or to devalue its currency, which will in its turn, if not accomplished with a rare nicety of judgment, lead to disturbances in foreign markets.

But inflation does more than breed depression. As we have just indicated, it tends to depress real wages by its effect on the distribution of real income. In fact whenever the demand for labour increases wages to a point at which inflationary processes begin to

operate the wage earner is likely to suffer. He is threatened first by the inevitable tendency for prices to outstrip wages and secondly by the risk of inflation giving rise to depression and consequential unemployment. The only escape from this dilemma is to check this rise in wages before it reaches the point at which the inflationary processes occur. These inflationary processes are likely to begin whenever wages increase more than productivity, unless—and the qualification is important—excessive profits are being earned and the profit margin can be cut without hindering enterprise.

In view of these facts, on the occasion of each threatened recession we must, before formulating over-all policies, give close consideration to each of the factors at play; we must do everything possible to break any monopolistic position that presents itself, in order to prevent shortages and bottlenecks from resulting from the remedial measures adopted.

2. THE IDEAL HIGH AND STABLE LEVEL OF EMPLOYMENT

We must be careful too in our definition and conception of our ideal high and stable level of employment. It obviously does not mean absolutely full employment of labour, machinery or natural resources, for such a perfect equilibrium between the three is never attained. Moreover, full employment of any of them is a conventional conception. Employment for how many hours a day; for how many days in the year; for how many years in the space of human life? As Sir William Beveridge has said, it is improbable that unemployment can be abolished completely in the sense of "getting every man and woman in the country who is fit and free for work employed productively every day of his or her working life".¹ There will always be a certain amount of seasonal unemployment, and short term unemployment for those in process of changing their jobs. There will moreover always be some unemployment on account of the ups and downs of individual industries, whether resulting from changes in demand or from changes in methods of production.

One of the objectives of economic policy that we gave in Part I of our Report was to assure "that, in so far as possible, no man or

¹ Sir William Henry Beveridge, "Killing the Fifth Giant", *The Listener*, October 14th, 1943.

woman able and willing to work should be unable to obtain employment for periods of time longer than is needed to transfer from one occupation to another, or when necessary, to acquire a new skill".¹ This objective is the formulation which we would ourselves give to that of full employment, or, to use an expression which we prefer, of a high and stable level of employment. It is generally impossible to foresee whether a contraction in the demand for some commodity is due to a change in taste that is likely to prove permanent or is only a temporary condition. But until some judgment on that point can be framed, workers will be reluctant to look for an alternative occupation involving a change in skill and possibly an uprooting of their homes. When the shift in demand is from one product to another requiring very similar skills in its manufacture, or when the shift in demand is from one industry to another in the same place, it may prove possible to effect labour transfers readily and willingly. But in the whole industry of any country there is likely to be a not inconsiderable aggregate of unemployment due to these constant shifts in demand and to the natural and indeed wise preferences of the individual worker to make as sure as possible how the industry with which he is familiar, in which he has a definite status and interest, is likely to fare before turning to another of which he is ignorant and in which he is unknown. Labour is not a fluid uniform power, but a miscellany of skills and more important still of human lives, experiences and attachments. But labour fluidity though limited is essential to prevent the twin dangers of unemployment and inflation.

3. THE NEED FOR LABOUR MOBILITY

The reduction, as employment becomes fuller, in the number of unemployed on which industry can draw must be compensated by greater mobility of labour. If expansion in one industry or area cannot be met by absorbing unemployed labour immediately at hand, it must be met by transferring labour from elsewhere. This implies a greater readiness on the part of workers to change their occupations and possibly also their places of work than has been customary in the past. Some aspects of the problem of labour mobility are discussed in the following chapter in connection with

¹ *Loc. cit.*, p. 14.

the phenomenon of partial or localized depression. We are here concerned rather with the implications of labour immobility in accentuating the danger of inflation under a policy designed to secure a high and stable level of employment.

As we have already implied the influences affecting mobility are many. They vary with national character, ways of living and social values. But everywhere three are of special importance and to these three we shall confine our attention in this chapter. They are:

- (i) the wage structure and the extent to which and rapidity with which wages reflect changes in the demand for labour skills;
- (ii) the policy and practice of trade unions with regard both to wages and to the admission of newcomers to their ranks;
- (iii) what we may perhaps call the skill structure of industry, the extent, that is, to which the industry of any country requires special skills for its conduct and the facilities afforded for acquiring new skills.

4. THE INFLUENCE OF WAGE STRUCTURE ON MOBILITY

Obviously the more readily relative wages respond to changes in relative demand for different types of skill, the more rapidly, that is, the inducements offered the worker respond to the real market needs, the more rapidly is labour likely to transfer from occupation to occupation according to those needs. This is a point which needs to be kept in mind by authorities responsible for fixing minimum wage rates and by employers and trade union leaders responsible for wage negotiations. Where, as in certain countries, minimum wages in a large number of industries are subject to regulation either by a single minimum wage fixing authority or by simultaneously negotiated collective agreements there is a natural tendency to adjust all wage rates by equal amounts or percentages. Such adjustments do not altogether preclude changes in relative wages since the rates fixed are normally minimum rates and employers in industries or occupations in which labour is in short supply may find themselves obliged in practice to offer higher rates. There is, however, some reluctance to depart from agreed rates and it is important therefore that any need which may exist for adjustments in relative wages should be recognized when the minimum rates are fixed.

5. THE INFLUENCE OF TRADE UNION POLICY

The increased bargaining strength of trade unions resulting from the assurance of a high level of employment may also have inflationary effects. Any one union may be able to secure a temporary gain by demanding an increase in wage rates, although the real effect of the gain will disappear as other unions follow suit and the general level of costs and prices moves upwards. In practice the better organized unions and those operating in monopolized industries (where wage costs can most easily be passed on in the form of price increases) are in a position to benefit at the expense of the community. Unless trade unions adopt a national policy under which wage changes are intended to reflect changes in relative demand and relative or general productivity, and not simply bargaining opportunities, there is likely to be a continual upward pressure in the price level which will become more severe when employment becomes more active, and will render it difficult to secure and sustain a high level of employment.

The stimulus to inflation in such circumstances would be greatly strengthened by any direct linking of wages to a cost of living index. When the demand for labour as a whole exceeds the supply a trade union in a strong bargaining position may be able to secure a wage increase greater than can be absorbed without a rise in the price of the product of the industry concerned; and if this product enters to an important extent into the cost of living index the result will be an automatic increase in wages in other industries as well. This in turn will bring about a further rise in the cost of living index and a cumulative inflationary process is thus established.

The pursuit of a general wage policy of the kind advocated above presents no doubt very serious difficulties. There will always be an area of doubt concerning the justification for a wage change even amongst the most dispassionate experts. Labour leaders cannot act without the backing of the rank and file of those they represent. To afford adequate information in digestible form about the state of national industry as a whole on which a sound judgment could be formed is itself a difficult task. To postulate that in opposition to apparent, immediate sectional interests a sound judgment will in all cases be formed and acted upon is clearly unrealistic. But despite all these difficulties it remains, we believe, true that we shall only be able to maintain high employment and

prevent inflation if trade unions as a whole think and act in terms of economic activity as a whole rather than in terms of their own craft or industry. It is indeed as impossible for a government to assure a high and stable level of employment without the whole-hearted co-operation of labour as it is for it to do so without the co-operation of the business leaders. But this co-operation can only be expected if the general public are convinced that government policies are based on considerations of public interest. Moreover a national wage policy postulates a national policy with regard to prices and profits. It presupposes also the willingness of trade unions to admit new members as demand for one skill or another increases. Failing such freedom, wages will tend to reflect simply the monopolistic power of each group of workers, and the national income and the standard of living of workers in the aggregate will be depressed owing to the inability of the productive mechanism to respond fully or promptly to changes in demand.

In countries where the degree of labour organization is roughly uniform in the different industries and occupations a proper national wage policy may be attained with the least difficulty. In others, where some sections of workers are better organized than others and are therefore in a position to advance their own interests at the expense of the rest of the community, this policy is likely to encounter serious resistance. It may well have to await an improvement in the standard of labour organization among the less organized industries.

6. THE INFLUENCE OF THE "SKILL STRUCTURE"

The skill structure of any society is of course complementary to its wage structure. Each skill is a separate entity with a distinct market price determined by demand and supply and various factors restricting the free play of these forces. The less skills differ from each other the easier it is to transfer labour, the greater the labour mobility. There are therefore two means affecting skills by which mobility may be increased. The one is to employ machinery necessitating a minimum of skill differentiation; the other is to afford facilities for training labour to new skills. Governments and business men should be alive to both possibilities. The tendency of modern mechanical invention has been towards simplification of operations and that tendency is likely to continue. It has been im-

peded to some extent in the past by the efforts of certain big undertakings to conserve the value of existing machines by buying up patents and then not using them. Such action directly impedes the spread of new mechanical devices and in many cases has no doubt checked progress; but a sudden outcrop of new inventions and new processes may have extremely unstabilizing effects, and there may on balance be an advantage in introducing them onto the market by a gradual process. We do not wish to dogmatize in any way on this rather intricate problem. But we would suggest that governments should reconsider their patent laws so as to prevent firms from suppressing or impeding new inventions.

On the other of the two means for promoting labour mobility, namely, training in additional skills, we commented in Part I of our Report.¹ Vocational training is of particular importance in connection with partial and regional depressions and we will therefore postpone putting forward any further suggestions under this head until the next chapter.

7. THE INFLUENCE OF THE ENTREPRENEUR

The extent, however, to which opportunities for alternative employment or for additional employment in existing industries are likely to arise must be largely dependent on the attitude of business leaders. We have already drawn attention to the need for co-operation and mutual understanding between the government and business men when a policy of expansion is adopted and to the danger, failing such understanding, of increased government spending being offset by decreased private investment.² The attitude of mind of the business community as a whole to the policies adopted by governments is indeed of fundamental importance. No less important are the policies adopted by all business undertakings which have or might acquire a predominant or monopolistic position in any branch of business. They may make or obstruct progress; provide or restrict opportunities for employment and production; promote or check recovery when economic activity has slackened. If they are willing always to endeavour to broaden the basis of their market by selling more at a lower price rather than less at a higher price, providing costs permit, they will greatly

¹ *The Transition from War to Peace Economy*, League of Nations, p. 66.

² Chapter XII, p. 182.

ease the task of governments when faced with the necessity of reviving business. If they refuse to do this, then additional purchasing power which is created in the economic system may go to waste in higher prices and fail to increase employment or real income. In such circumstances governments must, in our opinion, supplement any general measures for increasing purchasing power by special measures designed to break price rings and establish effective competition.

8. THE NEED FOR A COMMUNITY EFFORT

The danger that a policy aimed at maintaining a high level of employment may produce inflation arises also from the opportunity which it may afford to organized economic groups to exploit their power by pressing for special advantages. We have insisted throughout this chapter that it is an integral part of such an employment policy that steps should be taken to enhance the mobility of labour, and that trade union leaders should adopt a national wage policy under which demands for wage increases will be directly related to increases in productivity and influenced by considerations of the general state of economic activity. This will require a sense of responsibility and a degree of economic statesmanship which it would be unreasonable to expect of one particular group if it is not shared by other groups and by the community generally. The leaders of labour can hardly be expected to forego the special bargaining advantages that may from time to time arise in particular sectors of the economy unless they can be confident that the general direction of public policy is to reduce unjustifiable inequalities of income and to promote the improvement of the general standard of living. In particular it will be necessary for governments to give labour the assurance that their policies are at all times directed towards increasing the income of the masses of the population, by preventing a wasteful misapplication of resources, by the promotion of efficiency in production through facilitating the application of scientific and technical developments and by the control of monopolies and monopoly profits. It will be necessary to prevent non-labour groups from securing special advantages through successfully pressing for higher prices for their products. In short, a policy for maintaining a high level of employment must be regarded as a community

effort from which all will benefit and to which all must make their appropriate contribution.

9. EMPLOYMENT AND PRODUCTIVITY

There is another point with reference to the possible consequences of a high level of employment which we should perhaps mention here. It is sometimes feared that such a state of employment may lead to a deterioration of workmanship and discipline and hence to a decline in productivity. Were such a deterioration to occur, it would tend at the same time to accentuate the danger of inflation, since it would reduce the rate at which money wages could rise without involving an increase in prices.

It is difficult to say how serious this danger might prove. Fear of unemployment as a means of maintaining the standard of efficiency and output is probably of importance only as regards the less stable and less competent individuals or groups of individuals. Sometimes, indeed, this fear has precisely the opposite effect. Behind the persistent tendency toward restriction of output on the part of industrial workers lies the deep-rooted and almost instinctive fear of "working themselves out of a job". Moreover, in so far as such inducements to efficiency are necessary, the possibility of being dismissed remains a serious deterrent, even though the general level of employment is high enough to offer somewhat better prospects for securing another job. The ever-present fear of unemployment and destitution does not provide an atmosphere in which a normal person can do his best work. For most people, positive inducements rather than negative threats are likely to elicit the greatest efforts and co-operation. The important contribution of joint production committees in accelerating war output in those countries where they have been established suggests one of the most fruitful ways of providing a positive stimulus.¹

A psychologically favourable atmosphere created in this way can be supplemented by economic incentives in the form of piece-work rates, bonuses for high output or for suggestions for the improvement of productive efficiency, etc. We feel convinced that a satisfactory standard of output and productivity is more likely to

¹ Cf. International Labour Office: Studies and Reports, Series A (Industrial Relations), No. 43, "British Joint Production Machinery", Montreal, 1944. Also W. Ellison Chalmers, "Joint Production Committees in U.S. War Plants" (*International Labour Review*, Jan. 1943).

be promoted by improving the conditions of work and offering rewards for good performance than by the constant fear of unemployment. Willingness to accept technological improvements, especially of a labour-saving type, would also be increased if the workers concerned could have greater confidence that aggregate opportunities for employment would not thereby be reduced. There is in fact important evidence that technical progress tends to be associated with expanding employment even in the industries in which it occurs. In the United States over the period 1899-1939 employment increased most rapidly, as a rule, in manufacturing industries characterized by speed of technological change and by sharp cuts in the quantity of labour required per unit of output and in labour costs, while employment rose slowly or actually declined in industries where innovation was slow and unit labour requirements and unit wage costs fell only slightly or moved upward.¹ Although the evidence relates only to one country, there is little reason to doubt that experience elsewhere was substantially similar. Furthermore, it seems reasonable to suppose that this relationship between improvements in productivity and expanding employment in the industries concerned will be maintained in the future.

10. WAGES, PRODUCTIVITY AND PRICES

Apart from the central problem of ensuring an adequate volume of expenditure, the main subsidiary requirements for maintaining employment are a co-ordinated wage and price structure to prevent inflation. Whether these conditions can be fulfilled by a rational and enlightened policy on the part of individual trade unions and employers, or whether there will be a need for some centralized government arbitration in fixing wages and prices, will depend on the social and political situation in different countries.

The aim of wage policy may be either to allow wages to rise in proportion to productivity, keeping the general level of prices stable, or to allow prices to fall as productivity increases, keeping the general level of wages stable. If the second alternative is adopted, although money wages are kept stable, real wages will rise in proportion to the fall in prices. The first alternative allows

¹ Cf. Solomon Fabricant: *Employment in Manufacturing, 1899-1939: An Analysis of its Relation to the Volume of Production*, National Bureau of Economic Research, New York, 1942, pages 89 and 112.

for the necessary adjustments in money wages to be made mainly through wage increases in the expanding industries, rather than by wage reductions in the contracting industries, which would be likely to meet with more resistance and difficulties. It involves a steady alleviation of the burden of debt without any detriment to the creditors. But this alternative implies that recipients of fixed income cannot benefit from the growth in national income to which the increased productivity gives rise.

This whole question of stability of prices and wages is well summarized in the British White Paper on Employment Policy, from which we quote the following paragraphs:

"There must always be room for the adjustment of wages and conditions, *e.g.*, on account of changes in the form, method or volume of production. Also there must be opportunity for the removal of anomalies in the rate of remuneration of different grades and categories of workers, both within an industry and between different industries. The principle of stability does mean, however, that increases in the general level of wage rates must be related to increased productivity due to increased efficiency and effort.

"An undue increase in prices due to causes other than increased wages might similarly frustrate action taken by the Government to maintain employment. If, for example, the manufacturers in a particular industry were in a ring for the purpose of raising prices, additional money made available by Government action for the purpose of maintaining employment might simply be absorbed in increased profit margins and no increase in employment would result.

"Stability of wages and stability of prices are inextricably connected. If the general level of wage rates rises and there is a corresponding increase in prices of goods for civilian consumption, the individual wage-earner will be no better off and there may be no increase in the total amount of employment available."¹

11. LESSONS TO BE DRAWN FROM THE DANGER OF INFLATION

As we have said above, we have insisted on the danger of inflation because inflation may give rise to the very depressions which it is our purpose to avoid or mitigate. But governments must not allow the fear of this danger to weaken their resolve to maintain economic activity. During the early stages of recovery from a depression, inflationary tendencies are not likely to arise. When they do become apparent, that should be accepted as a sign that there has been some error in policy which requires rectification. If they

¹ Cmd. 6527, pp. 18-19, paragraphs 50-52.

occur in a particular industry or a particular area, the endeavour to attain a high level of employment throughout the whole economy should not be abandoned on that account, but measures should be adopted to break down the obstructions to greater production which they reflect.

CHAPTER XV

UNEMPLOYMENT IN SPECIAL AREAS AND INDUSTRIES

1. PARTIAL DEPRESSIONS AND LABOUR MOBILITY

We have been considering so far mainly the problem of general unemployment, a situation in which, either for cyclical or structural reasons, there is a general deficiency of demand, involving unemployment in all or most sectors of the economy. We must now turn to the special problems of partial unemployment, a situation in which depression is confined to a few industries or localities, labour in the rest of the economy being more or less fully employed.

This problem may arise in various ways, but, as we observed in Chapter II, is closely bound up with the immobility of productive factors, particularly labour. It results from shifts in the direction rather than changes in the general level of demand, and is thus mainly a structural and not a cyclical problem. It is true, as we have seen, that the incidence of cyclical depression is generally more severe on certain industries—those producing capital goods and sometimes, also, the export industries—than on others; and in so far as these industries are localized, this involves an uneven geographical distribution of unemployment during depressions. But the essence of the problem in this case is the decline in the general level of demand, and the remedy for this type of local unemployment must be sought in the recovery of national income as a whole.

The phenomenon of partial depression with its specific problems—co-existence of unemployment in certain areas and inflationary pressures elsewhere—may also arise at the top of a cyclical upswing. It is unlikely that an expansion would affect all localities and industries in proportion to the available labour supply in each. Hence, when an upswing develops faster than it is possible to shift labour, a spotty situation is likely to arise, with full employment and rising costs and prices in some areas while depression and unemployment still linger in others. It is precisely for this reason that it is so difficult to push a full employment policy beyond a certain level—except under special conditions, as, for instance, in wartime when exceptional measures are taken to distribute work and shift labour.

The situation we are more particularly concerned with in this chapter is that arising from structural shifts in production and demand, not associated with any deficiency in the level of demand as a whole.

2. STRUCTURAL CAUSES

Large structural changes in demand and supply arise in various ways—among the most important of which in recent years have been those connected with the course and consequences of war. The process of mobilization for the present war provided many examples of this phenomenon. Both the geographical and the industrial distribution of demand during war inevitably differ substantially from that in peace. Consequently, as demand expands more sharply in certain industries and areas, acute labour shortages and bottlenecks begin to appear, while unemployed resources are still available in contracting peacetime industries. The pace at which war industries can expand depends on how rapidly the resources released from the contracting industries can be transferred. Occupational mobility had to be increased by training schemes, relaxation of trade union restrictions, and dilution of skilled labour with unskilled and female labour. Geographical mobility is in most countries more difficult to promote, and attempts were therefore made in most belligerent countries to locate the expanding war industries in the areas where labour had been released from civilian production and services.

The reconversion process after the war will give rise to many of the same problems. As civilian production expands, shortages of labour in certain industries will soon begin to appear even though pools of unemployment remain in the neighbourhood of the over-expanded war industries. Many export industries will find that they have lost their old markets, while in these markets other industries built up during the war will not be able to meet foreign competition. The problem will have to be tackled in the same way as during the process of mobilization. Assistance may be given to workers in the declining industries and demobilized soldiers to facilitate transfer and, if necessary, provide training for peacetime occupations. Where during the war production has involved extensive population shifts, the need for the reverse process may be mitigated in some cases by promoting the establishment of new industries in these areas.

But we are concerned in this Report rather with the structural changes which arise in peacetime. Demand is constantly shifting as a result of technical progress and changes in taste or fashion, and as the world recovers after this war and income per head mounts to and above the level it reached before, demand, as we have shown, is likely to become more unstable. As organized research and more scientific methods of production lead to constantly larger crops of new inventions, productive processes may also become more unstable. If this happens, there will be a growing need to render the organization of industry and agriculture more adaptable and to render labour more fluid, trained in more than one skill and able and willing to move rapidly from one activity to another.

When the structural changes are not too rapid, and when the necessary shifts are mainly industrial and not geographical, they may be met largely by changes in the allocation of young workers entering employment for the first time. This process can be facilitated by vocational guidance and training in schools to adapt the labour supply to the existing and prospective demand. In one-industry areas in which children traditionally follow their parents' callings, the schools and the employment agencies can perform a particularly important service by the effective presentation of the range of opportunities elsewhere. But when the shift is too rapid to be met by reallocation of new entrants into industry the problem is more difficult. Experience in Great Britain showed that although older workers were less likely to lose their jobs than younger ones, their chances of securing re-employment were very much worse.¹ Both for social reasons and in order not to waste valuable manpower, special measures may be desirable to provide employment for older workers who have to change their occupations as a result of structural changes or because the work they were doing was too strenuous. In some industries certain lighter occupations are reserved for older or disabled workers, and this principle might with advantage be extended to the economy as a whole. But what is most important is to have sufficient training facilities for teaching new skills.

¹ In Great Britain the risk of men over 60 being unemployed at all is about half as great as the average, whereas the risk of their being unemployed for a year or longer is $2\frac{1}{2}$ times as great (cf. Sir William Henry Beveridge, "An Analysis of Unemployment", *Economica*, 1937).

3. MEANS FOR PROMOTING MOBILITY

Mobility as between occupations may, however, be hampered by trade union restrictions on the freedom of entry into new trades. These restrictions developed in certain industries as a natural and inevitable reaction to the persistence and constant fear of unemployment. If, however, governments succeed in maintaining a steady high level of employment by the various means discussed above, trade union restrictions on entry would lose their justification. Instead of being regarded as a safeguard against unemployment, their continuation would appear as an unjustifiable exploitation of a monopoly position with a view to securing relatively high wages for the workers in the industry concerned at the cost of unemployment or unduly low wages elsewhere. The pressure on the part of the under-privileged and exploited workers for the removal of such restrictions would naturally stand a greater chance of success if the workers in the protected industry were not themselves threatened with unemployment.

Partial depressions are more serious when they are concentrated in localized industries than when they fall on industries which are geographically well distributed. Localized depressions may arise either because demand has shifted away from the products of industries situated in the particular area; or, in the case of extractive industries, because the raw material deposits on which activity in the area was based have become exhausted. Depressed agricultural areas may develop in a similar way as a result of over-exploitation and soil erosion.

Whatever the reason, the initial depression tends to have cumulative local effects. Distributive and other services become depressed as a result of the decline in income and employment in the depressed industry, labour becomes demoralized and the fall in local tax receipts tends to be compensated by a rise in tax rates. All these factors combine to discourage the establishment of new industries in the affected area.

The problem can be attacked from two directions, which are, however, to some extent incompatible with one another. The first approach consists in encouraging and assisting the establishment of new industries in the depressed areas to absorb the local pool of unemployed labour. The second possibility is to promote and

facilitate the transfer of labour away from the depressed areas to areas and industries where there are shortages.

The remedies adopted are likely to vary with the causes of depression. There may be some depressed areas which are inherently not unsuitable for industrial development but which happen to have been the site of an industry which has declined, and have so suffered from the cumulative effect of depression on the neighbouring industries and services, on the local finances, and on the efficiency and morale of the workers as to deter the establishment of new enterprises. In these cases it is mainly the psychological resistance that has to be overcome, and once a new industry is established it may prosper without further assistance.

In fact, while governments may do much to facilitate labour transfer, that alone may not be enough. It may be necessary for the government itself either to start new industries or to offer special inducements to business men. Very large adjustments had to be made after the last war as a result of new national boundaries. Thus, many of the industries in areas which had been within or proximate to the frontiers of the old Russian Empire had been designed to meet the needs of the Russian market and had to be adapted to new market conditions. Some were granted high protection so as to secure to them the whole of the generally smaller but somewhat richer local market. To some, government credit was advanced. Some decayed, and the governments stimulated alternative industries or areas by direct assistance, the remission of taxes on new undertakings over a series of years, and other means.

In Austria the Government attempted, and with some success, to foster a new national tourist industry by the construction of roads, special railway facilities, etc. In both Estonia and Roumania assistance was afforded to local mining undertakings, shale and coal, by the utilization of their products on the Government-owned railways. In every case the government must weigh the cost involved against the chances of profitable business proving possible after a period of transition and the need for special assistance during that period. A permanent subsidy, whether direct or indirect, is a proof of uneconomic use of resources which can be justified, if at all, only on non-economic grounds.

A major industry which has been most widely affected by new competition resulting from technical progress in the last twenty

years, especially in countries with high industrial density, has been railway transport. Railways have indeed suffered not only from the greater elasticity of road transport but also from the fact that the main capital outlay for motor-hauling firms—the construction of roads—has been furnished gratis by the public authorities. When the railways themselves have been able, with or without government assistance, to adapt their own practices to meet the new competition, for instance by the institution of light, rapid motorized or diesel-engine trains or by using lorries which can run on both track and road, they were generally able to continue to work at a profit. But when any assistance rendered from public funds took finally the form of a balance-sheet subsidy, the tendency was for the need for this subsidy to grow. It is indeed of utmost importance that governments when called on to render assistance should regard the problem before them rather as a technical than as a financial one.

In Great Britain unemployment in the inter-war period in certain areas dependent mainly on exports was particularly persistent and severe. As hopes of natural recovery gradually waned and after it had become apparent that local effort and spontaneous growth of new industries would not suffice, the Government took a number of measures both to get new industries established in the less derelict depressed areas, and to assist the migration of some of the surplus population away from those areas where there seemed little hope of revival. The measures were applied tardily and with limited success; but it may be worth discussing them in somewhat greater detail as illustrating the type of policy that may be applied and the difficulties encountered.

In order to attract new industries to the Special Areas, grants were given to local authorities for the building of hospitals and public health projects. Further substantial sums were spent in settling unemployed persons and their families on the land. This was, however, largely a measure of relief; it required continued heavy subsidies and contributed little towards reducing the volume of unemployment in these districts as a whole. Finally, attempts were made to encourage the settlement of private industry in the depressed areas. Firms in other parts of the country were circularized with a view to ascertaining whether they were willing to establish plants in the Special Areas, but with mainly negative results.

A more promising line was the establishment of Trading Estates, providing small modern factories at moderate rents, with communal amenities for workers which would have been too expensive for firms to finance individually. This development, which began only a few years before the war, met with considerable success.

A further means of encouraging private enterprise in the Special Areas was the provision of financial assistance. Firms in depressed areas were at some disadvantage in securing local private finance as compared with those in more prosperous districts, in addition to the fact that their own financial resources tended to be more restricted. In 1936 the Special Areas Reconstruction Association was established with Treasury assistance to provide loans up to £10,000 at low rates of interest for periods up to five years for establishing plants in the Special Areas.

Another type of financial assistance provided was the offer by the Government to pay, wholly or in part, the rates, rent and income tax of new firms established in the Special Areas for a specified period, usually three to five years. This offer was designed to remove the deterrent effect of the exceptionally high local rates in these areas, together with other disadvantages, but surprisingly little avail was taken of it.

In some of the remote mining valleys of Scotland and South Wales where the coal measures have been practically exhausted, local recovery was impossible and a solution had to be sought in population transfer. An Industrial Transference Board was accordingly set up in 1928, to assist the transfer, mainly of coal miners, to other areas and occupations. Most of the workers were moved to take up specific vacancies, largely on public works. Apart from finding vacancies, the Government gave grants towards the costs of lodging or removal for the married men, and for single men advances on their earnings and payment of railway fares to the new place of work. In the beginning a small number of carefully selected young men were assisted to migrate to more prosperous areas without definite jobs being provided in advance, and most of them succeeded in finding work. Financial assistance to cover the costs of removal of workers was supplemented by the provision of retraining facilities. For those who had been unemployed for long periods, Transfer Instructional Centres were established to

rehabilitate and revive habits of work rather than to teach any particular trade.

Special measures were found necessary for the transfer of juveniles. Apart from grants to cover travelling expenses and maintenance, basic training facilities and welfare schemes were provided.

Despite all the measures adopted in the inter-war period the amount of industrial transference from the depressed areas in Great Britain was small in relation to the excess unemployment there, and the greater part of it took place in fact spontaneously and without assistance.¹ The main reason for the low scale of migration was undoubtedly the insufficient level of demand for labour in the rest of the country. If demand as a whole is high enough to ensure success in securing work in another area, some movement will automatically take place. In the absence of this assurance, state assistance, training facilities, etc., can be of limited avail. We see, therefore, that the main remedy for partial unemployment is the same as for general unemployment: the maintenance of an adequate level of demand in the country as a whole. Only when this basis exists will additional measures designed to promote mobility be of any avail. But granted it exists, if workers are fully informed about the jobs available in other parts of the country, if they can be trained for new jobs without expense, and if removal and travelling expenses are paid for them they will be prepared to accept the risk and discomfort of moving with a lower prospect of reward than if these facilities are not available to them.

It is frequently suggested that liberal unemployment benefits act as a bar to mobility. In the absence of general family allowances this is likely to be true for unemployed persons with large families where the number of dependents is taken into account for benefits and not for wages. But apart from the possibility that unemployed men with large families may actually suffer a reduction of income by taking a job, it is conceivable, especially after a period of prolonged unemployment, that some workers may prefer idleness on a bare subsistence level to taking a new job at a reason-

¹ Between January 1936 and June 1937, 30,000 men were transferred by the Ministry of Labour, while 61,000 moved on their own account. Royal Commission Evidence.

able wage. For this reason modern schemes of unemployment insurance make the receipt of benefits dependent on willingness to accept suitable work or, in some cases, to undergo training for jobs that are available. It is important that these systems should be administered with full attention to the importance of encouraging mobility.

We have considered up to this point local or partial depressions caused by structural changes which could not themselves be influenced by policy. But partial depressions frequently occur on account of changes of a less permanent character. Thus the export industry of a country may be adversely affected by some passing difficulty in its foreign markets or more seriously by such a general breakdown in trade as occurred in 1929. We deal with some of these problems in Chapters XIX and XX.

CHAPTER XVI

UNEMPLOYMENT DUE TO CHRONIC DEPRESSION

1. THE POSSIBILITY OF A LONG-TERM DEFICIENCY OF PRIVATE INVESTMENT

In the preceding chapter we considered the case of unemployment in particular areas or industries due to shifts in expenditure which might, in the absence of appropriate policies, prove of very long duration. It is frequently argued that a general chronic unemployment may occur from a different cause, namely, a permanent tendency for savings to exceed investment. Theoretically such a state of affairs might arise in any country endowed with an abundant capital equipment for the satisfaction of consumers' needs, in which the distribution of wealth or the income per capita was such as to permit of large savings being effected. It would only arise, however, if people were reluctant to increase their consumption expenditure to the extent permitted by the increase in their income.

Opinions differ as to whether unemployment of this type has ever in fact existed, although it is frequently suggested that the long period of economic stagnation and unemployment in both the United States of America and the United Kingdom before the present war was to be explained by such an excess of savings. Whatever the validity of this view may be, the risk of this form of unemployment presenting itself for some considerable time to come has been greatly diminished in countries in the scene of warfare, owing to the enormous loss of fixed capital that they have suffered. It is not impossible, however, that at some date after the war, when the most urgent tasks of reconstruction have been completed, a state of stagnation of unforeseeable duration may arise, and we feel, therefore, that it is necessary to bear this possibility in mind. Should there be a tendency for savings to exceed private investment opportunities, it is clearly the duty of governments to take measures to prevent the loss and unemployment which that tendency would cause.

2. STIMULATION OF PRIVATE INVESTMENT

As we have remarked already, the total volume of private industrial investment depends on profit expectations, which will be

affected not only by consumers' final demand, but also by the cost of capital, the cost of capital goods, and the willingness to take risks. If savings tend to be excessive, the natural result should be a fall in the price offered for them, and, if this occurs or is brought about deliberately by a persistent policy of cheap money, it should increase investment opportunities. Such a cheap money policy is indeed the first obvious means for attempting to overcome chronic unemployment of the type we are discussing. We have already pointed out how considerable the influence of interest rates may be in the case of the housing industry. In the heavy metal and mechanical industries its importance is not likely to be so great. But the rate of interest is in all cases of some significance, and for any form of permanent construction, whether on factories or on privately owned public utilities, is likely to be of very considerable significance.

Frequently profit prospects may be enhanced by public development schemes which reduce production costs—the provision, for instance, of communications or electric power. Such public investments may not themselves be remunerative from the point of view of a private investor, but the total yield on national capital may be raised by them. They would offer increased scope for profitable private investment both directly in the areas concerned and indirectly in industries using or consuming the goods produced there.

Finally, industrial and agricultural research may result in discoveries which afford new opportunities for investment, either by leading to the manufacture and use of new classes of consumers' goods, or by so reducing the cost of production that certain goods of this class can be made available to a larger proportion of the total population than heretofore. The key to the solution of chronic unemployment, if it ever manifests itself, must indeed lie in the growth of consumers' demand; and it is difficult to imagine a society in which all human needs are so adequately satisfied that that growth cannot be stimulated. It may be stimulated either by reducing costs in any of the ways we have suggested, or by more efficient organization of individual enterprises, or by government enterprise; it may also be stimulated by increasing the proportion of national income rendered available for the purchase of consumers' goods. We shall endeavour to show in the next section how this

change in the use of income may be effected by measures designed at the same time to lower the cost of goods or services to the general public.

3. STIMULATION OF PRIVATE CONSUMPTION

With any given national income, if less is saved more will be available for consumption. An alternative approach to that considered above, therefore, is to attempt to influence the volume of savings. The volume of savings is to a large extent a function of the existing distribution of national income. We observed in Chapter IX that income distribution might be affected either by measures primarily intended to increase the productivity of the lower income groups or by fiscal measures causing a redistribution of income after it was earned. We drew attention in this connection to the risk that the latter procedure might check progress owing to the influence of high taxation on enterprise. If, however, a situation arises in which there is a permanent seepage of savings so that they go to waste in any case, the objection to income redistribution by fiscal measures is greatly reduced. In such circumstances, moreover, there is, in our opinion, a strong probability that the stimulus to investment caused by the growth of the purchasing power of the lower income groups will outweigh the disincentive influence of high taxation rates. We suggest, therefore, that should chronic unemployment of this type ever present itself, governments should adapt their fiscal systems in such a way as to stimulate consumption expenditure and restrict saving. A high level of consumption may be promoted both by the measures we consider in the following section and, for instance, by increases in the provisions for old age.

4. PUBLIC EXPENDITURE

Most of what has been said in previous chapters concerning public expenditure as a means of counteracting cyclical depressions applies equally well to public expenditure as a means of counteracting any long-run tendency to underspend.

It seems unlikely that within the foreseeable future, even in the richest countries, there will be any lack of outlets for public expenditure which will be of real value to the community. In all countries today the social services are still in their infancy. Everywhere education is inadequate and restricted; nowhere is medical

service available on equal terms to all; nowhere is the national equipment for hospital service, are the means of communication or the electrification and telephone systems sufficient to meet more than a part of real needs; nowhere is the housing accommodation for all the less privileged classes of society such as to permit of good health or even personal decency. Should a chronic tendency for savings to exceed private investment opportunities present itself before these and other social services have been perfected, the state should find no difficulty in utilizing those excess savings for the good of the whole community. Unemployment due to this cause is indeed, in our opinion, a much easier problem to solve than unemployment of a cyclical nature in a community where private enterprise predominates.

The consequences of deficit financing in increasing the national debt would, of course, be much more marked in the case of a permanent tendency towards underspending, since with the cyclical element absent there would be no periods during which debt would stop increasing or could be reduced. If expenditure, however, was increased only to the amount of the savings which would in any case have gone to waste, it would represent no cost to the community, but a net gain on account of the services rendered by it and by the indirect effects of the employment to which it gave rise. This gain will be reflected in an increase in the national income, at least equivalent to the expenditure made and therefore more than adequate to cover the service of the debt. But important problems with reference to the indirect effects of the increase in the national debt which we discussed at length in Chapter XII do arise.

The Delegation would not advise, however, that governments embark on a programme of indefinite expansion of the public debt merely to offset a condition of secular stagnation. It would advise rather that a country faced with such a prospect review the general structure of its economy including the incidence of its taxation, its commercial policies, its inducements to enterprise, and its provisions for social security with a view to achieving conditions in which the productive possibilities of its industries are made to contribute directly in higher measure to the standard of consumption of its people.

In this connection one factor should be emphasized here. It is

improbable that the financing of the debt will be such as to leave the distribution of income unaffected. If the debt were largely held by richer people and the tax system were mainly regressive, then the financing of the debt would lead to a continuous redistribution of income from the poor to the rich. This is a situation which the public authorities would have to be particularly careful to avoid in the case of a mature economy where savings tended to exceed investment outlets. For in such circumstances the government's fiscal policy would tend to intensify the tendency towards chronic underspending and unemployment. In fact, however, the public debt in most countries today is not by any means held exclusively by rich people, and tax systems tend to become increasingly progressive.

5. FOREIGN INVESTMENT

In Chapter XIII we considered the influence of capital migration on the spread of booms and depressions and the means by which these fluctuations might be reduced. Foreign investment may also be usefully employed to counteract any longer-term tendency that may arise in highly industrialized countries for savings to exceed acceptable investment opportunities. For it is clearly to the advantage of all that surplus savings should be employed for the development of under-developed countries rather than allowed to go to waste.

6. THE GROWTH OF LEISURE

In contemplating the eventual transition from a high investment to a high consumption economy, we are admittedly taking a long view. We are envisaging a period, far beyond the horizon in most countries, when the most urgent problems of low productivity and consequent poverty have been solved. In this long-run prospect of economic and technical progress we must not neglect one of the most important articles of consumption which we should hope to see extended on a mass scale in the course of time: that is, leisure. Considerable progress has already been achieved in the more advanced countries in reducing hours of work, abolition of child labour, raising the school-leaving age, enabling workers to retire when they are too old or unfit for work, and in some cases providing holidays with pay. Nevertheless, even in these countries, large sections of the population work far harder and longer than

is consistent with preservation of full health and efficiency, quite apart from the lack of time and energy to devote to cultural and recreational activities.

As and if a situation of stagnation appears in mature economies, it would seem reasonable that an increasing proportion of the spare resources released by technical progress should be devoted to increasing leisure, particularly among the more hard-worked sections of the population. We must not allow painful memories of the evils of unwanted leisure in the absence of adequate income to blind us to the benefits of wanted leisure for those whose primary material needs have already been assured.

CHAPTER XVII

INTERNATIONAL MONETARY IMPLICATIONS OF NATIONAL ANTI-DEPRESSION MEASURES

The economic situation of an individual country endeavouring by the various measures discussed in preceding chapters to maintain a high and stable level of employment may be seriously affected by deflationary or inflationary influences from abroad, resulting from the failure of other countries to maintain economic activity or to avoid inflation. We have explained the mechanism by which expansion or contraction may spread from country to country in Chapter VI, and wish now to consider first, what autonomous measures a country suffering the impact of these external influences can adopt in order to support economic activity and mitigate deflationary or inflationary disturbances and secondly, what international machinery is required to supplement autonomous action or to prevent such action proving in its turn prejudicial to other countries.

Our discussion on this subject, which relates largely to balance of payments problems, applies both to the industrial states which we have had mainly, though by no means exclusively, in mind up to now, and to countries largely dependent on the production of crude products to whose special problems the next two chapters are devoted. It is important to note that the following discussion does not apply to the balance of payments difficulties which many countries will have to face immediately after this war. The nature of these difficulties, the possible policies to be pursued, and the lines of international co-operation that will be required have been dealt with in Part I of our Report covering the transition period. During the transition period there will be an urgent need, both for consumption goods and for capital rebuilding. In it, the danger of unemployment will arise, not out of an insufficiency of aggregate demand such as characterizes cyclical depressions, but from inadequacy of suitable productive and transport facilities and shortages of raw materials. Many countries in urgent need of primary imports will have no exports to offer in exchange, and furthermore in all too many cases, no foreign reserves with which to finance essential imports pending demobilization and the re-

establishment of peace-time industries. The difficulties they will have to face will differ radically from the balance of payments problems dealt with in the present Part of our Report, which are those that may be expected to arise after the transition period when peace-time economic activity has been largely restored and reconstruction has been carried to the point where different countries are again in a position to exchange their goods and services.

1. DEFLATIONARY INFLUENCES FROM ABROAD AND OFFSETTING POLICIES

We shall start with the situation that arises when a country finds its balance of payments deteriorating because of a fall in the demand for its exports. The income of its exporters will fall, and if nothing is done to counteract it, a cumulative deflationary process may set in, particularly if the economy of the country is largely dependent on the export industries affected. In this situation the choice of appropriate policies will depend upon a diagnosis of the predominant factors leading to the fall in export demand.

The drop in exports may be due to strictly cyclical factors. The foreign markets may be experiencing a cyclical depression with a resultant decline in their foreign purchases, which there is no reason to assume will prove of long duration. What in these circumstances should the country affected do? Should it allow the depression to spread from its export industries throughout its economy, or should it increase domestic expenditure to compensate for the reduction in foreign expenditure on its exports? In our opinion there can be no doubt that, in so far as may prove practicable, a policy of compensatory expansion should be adopted in these circumstances. To the extent that employment depends on total expenditure, it is essential for the maintenance of employment that total expenditure should not be reduced; and total expenditure in this case can be maintained if the temporary fall in foreign expenditure on the country's exports can be offset by an increase in domestic expenditure. In this way a country may prevent or at all events counteract the entry of depression from abroad.

This is the policy required for domestic stability; but it does nothing to remove the deficit in the balance of payments resulting from the fall in exports. The deficit must be met out of the coun-

try's gold and foreign exchange reserves. Indeed, the policy of compensatory expansion is practicable only in so far as there are adequate reserves of international means of settlement. If such reserves are inadequate, then even a small and temporary depression in foreign demand, instead of being offset in the manner indicated, may necessitate measures designed to restore promptly equilibrium in the balance of payments.

The policy of compensatory expansion is intended not to raise total expenditure, but to prevent it from falling. Since, therefore, the national income is not raised above its previous level, there is no reason to expect this policy to produce an increase in imports. But imports would of course be higher than if the country allowed depression to spread to its domestic economy. This means that the discrepancy in the balance of payments, and the amount of reserves required to meet it, are of necessity larger with a compensatory national income policy of the type described than they would be if the country left things to take their "natural" course.

With regard to its effect on the volume of employment, the policy of compensatory expansion is inevitably subject to limitations which vary in different countries according to the type of goods exported, the relative importance of the export trade in the total economy, the mobility of labour as between export and home-market industries, etc. Ideally, in order to prevent even local or frictional unemployment, the increased domestic expenditure should be directed to the same goods for which foreign demand has fallen off. But apart from exceptional circumstances, this is not likely to be practicable. Just as a road-building programme is not likely by itself to cure all unemployment in, say, the textile industry, so the compensatory domestic expenditure is not likely to prevent a partial depression in the export industries. It should, however, be possible to prevent a general and cumulative depression of the national economy in the circumstances considered; and that is the primary object of the policy suggested.

Little difficulty in the pursuit of such offsetting policies will be experienced by a country with a big internal market which it normally satisfies largely itself. A country, on the other hand, whose productive equipment is mainly designed to meet the needs of its export markets rather than its domestic market, or a "one-crop" country, will obviously have a much greater difficulty in

applying an effective compensatory policy than a country less dependent upon either exports (and therefore imports) in general or upon the export of a single export commodity. Such countries are indeed necessarily to a greater or less extent at the mercy of the policies adopted by their trading partners. To them, internationally concerted policies for the maintenance of a high level of employment, which we discuss in Chapter XX, are indeed indispensable. In the absence of such policies they may be driven to render their economies less dependent on foreign trade by changing the whole structure of their productive mechanism. But, while these inescapable limitations to offsetting policies must be recognized, it remains true that the spread of deflationary influences can only be prevented by such policies, pursued if possible in unison, and if that proves for any reason impossible, by each country to the greatest extent that its particular circumstances permit.

Up to this point we have considered cyclical factors only. But a fall in any country's exports may result from a deep-seated shift in foreign demand, implying a more or less permanent loss of markets for the export products in question. In these circumstances an offsetting policy alone may prove inadequate. Measures must be applied to adapt the structure of production to the new conditions. These measures may be directed to raising the competitive power of the affected country abroad by increased productive efficiency—by the installation, for instance, of more modern machinery or by the improvement of managerial methods. They may be directed to the development of alternative export outlets or to substituting domestic products for some classes of goods previously imported. We have discussed this subject already in Chapter XV, and will therefore confine ourselves here to drawing attention to two points which should not be overlooked. The first is that during the period of adaptation the country in question will probably suffer some loss of real income, not only because some temporary unemployment is likely to occur while workers shift from one employment to another, but also because the productivity of the workers in their new occupations is not, at first in any case, likely to prove as great as it was previously. Loss of trade is likely for a time to cause loss of income. The second point, which we have already mentioned in Chapter XV, is that a vigorous programme of adaptation will be facilitated if domestic business

in general, and hence aggregate domestic demand, is active. Governments would be well advised, therefore, to accompany their measures of structural adaptation by compensatory policies in so far as may prove practicable.

Our discussion up to this point has gone to show that a falling off in exports caused by external influences should be offset, both when it is of a cyclical and when it is of a more permanent character, but that in the latter case these policies should be accompanied by direct measures designed to achieve structural adaptation. In both cases, however, the balance of payments situation of certain countries may render the full application of such policies difficult. We have to consider, therefore, how the balance of payments can be adjusted. There are two possibilities. The passive balance may either be covered by an outflow of gold (or other international means of payment), or it may be corrected by adjustments of the rate of exchange or by commercial policy. We are neglecting for the moment those methods of correcting the adverse balance, which—however desirable in themselves—lie outside the power of the country concerned; the balance could, for instance, be corrected by expansion of income, increased foreign investment, or removal of import restrictions in the countries from which the deflationary influences come.

Whether it is more appropriate to cover the deficit by parting with liquid reserves, or whether an attempt should be made to correct an adverse balance, depends mainly on whether it is judged to be temporary or permanent. To effect a permanent change in the balance of payments, the measures which we have just discussed to change the internal structure of production will be required.

If the cause of the balance of payments deficit is judged to be temporary—if it is due, for instance, to a bad harvest or to a cyclical setback in one of its foreign markets—the country should use its reserves of international currency to carry it over until the other country recovers. If reserves are insufficient, recourse may be had to short-term borrowing abroad. Structural changes are difficult and costly and not worth undertaking if foreign demand is likely to recover shortly; moreover, they may cause disturbances abroad. If the cyclical set-back abroad is so intense or prolonged that a country cannot meet the adverse balance in its international

payments by reducing its international monetary reserves or by using its international borrowing facilities, then the case clearly calls for co-ordinated international action along the lines discussed in section 8 below.

But if the passive balance arises as a result of some structural factor, a persistent tendency to depression or a permanent change in commercial policy in another country, or because of a lasting change in taste, so that the drain on international reserves would be continuous, some adaptation of production will be unavoidable.

The measures which we have just discussed for effecting this adaptation may have to be accompanied by policies intended to have an immediate influence on the balance of payments of the country in question. The policies for adjusting the balance of payments may take any or all of the three following forms: (1) devaluation, (2) commercial policy and (3) exchange control.

As far as the balance of trade is concerned, all three methods operate either by restricting imports or promoting exports, or by a combination of the two. But their secondary effects may be widely different and exchange control may be used also to influence the capital balance. A devaluation of the currency has at first the same influence as a flat *ad valorem* duty on all imports and a subsidy on all exports; the extent to which each import is cut down and each export increased will then depend simply on the reactions of supply and demand. Consequently, unless the devaluation is carried too far or gives rise to competitive devaluation the benefits from the international division of labour are only affected to the minimum extent that is necessary to bring the balance of payments of the country devaluing its currency into equilibrium.

The second method of adjustment, which we have for the sake of brevity termed commercial policy, may take various forms; but its purpose must be either to check imports or to stimulate exports. In practice restriction of imports has in the past been more frequently employed than stimulation of exports. Moreover, it tends to be more selective than devaluation, in the sense that certain goods are generally subjected to more severe import restrictions or benefit by greater export subsidies than others. In consequence it tends to impede the international division of labour and the exercise by the consuming public of their power to purchase where

costs are lowest. While exchange depreciation is non-selective, import restrictions of all forms and export bounties of all forms too frequently protect not those most efficient in production, but those most efficient in exercising political pressure. Import duties have, however, this advantage over export bounties, that they are universally known, may be modified by international agreements, and can be bound for periods of time by such agreements. But both may be used in a selective manner to diminish the risk of instability through diversification, and import duties may be used as a form of rationing in order to assure that a country's export proceeds are devoted to the most essential import requirements. When import restrictions take the form of prohibitions, specific quotas, etc., trade is likely to be forced into bilateral channels and a discriminatory treatment of the trade of other countries is likely to occur.

Exchange control as an instrument of commercial policy is open to the same objections as direct quantitative controls, with the additional and serious drawback that its operations are not made public though indeed the same is true of certain quota arrangements. The following passage from a study prepared by Professor Jacob Viner for the League sets out forcefully and succinctly the dangers of quantitative restrictions:

"The three major types of direct governmental regulation of foreign trade are: exchange controls applied to commercial transactions; import quota systems; and government monopolies of foreign trade.

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Against all three of these, though in different degrees, the charges can be made that:

(1) They tie up diplomacy closely with the detailed conduct of foreign trade and thus promote international controversy and facilitate the harmful injection of political and military considerations into trade relations;

(2) They lend themselves more effectively than ordinary import duties to the application of monopolistic methods to foreign trade, to the economic injury of the world as a whole;

(3) They promote bilateralism in foreign trade, at the cost partly of economically-superior multilateral trade and partly of the suppression of profitable foreign trade;

(4) They lend themselves to discriminatory treatment of the trade of different countries for economic or political purposes;

(5) They promote, or even require for their execution, the development of internal monopolies and the restriction of the field for private enterprise, and especially small-scale enterprise;

(6) By placing other countries not following similar practices in a position of relative disadvantage in trade-bargaining, once established in some countries they tend to spread to other countries."¹

2. EXPANSION OR INFLATIONARY INFLUENCES AT HOME AND THE TRADE BALANCE

Up to this point we have considered the steps which might be taken by a country suffering from a deterioration in its balance of payments due to deflationary influences from abroad. Before turning to the obverse case of inflationary influences from abroad, we wish to consider first the case of difficulties in the balance of payments arising from a policy of expansion or from inflationary influences at home, and secondly, some additional implications of the conclusions we have so far reached.

It is important to realize that a country which at a time of general depression embarks on a policy of expansion of output and employment along the lines recommended in earlier chapters of our Report will, if other countries fail to keep in step with it, soon experience a drain on its international reserves. As we have shown in Chapter VI, its imports will rise and exports will lag behind. An expansionist policy, even if inflation is avoided, leads to an increase in aggregate demand, some part of which will be for goods purchased abroad. Moreover, it is likely to be accompanied by a recovery of prices which may depress somewhat the current level of exports.

The increase in the demand for imports on the part of an expanding country is precisely the mechanism by which expansion is transmitted to other countries. If other countries fall quickly in line the exports of the expanding countries will again rise and a new equilibrium may be reached on a higher level of exports and imports. Later in the present Chapter we discuss the international

¹ *Trade Relations between Free-market and Controlled Economies* (League of Nations, 1943. II. A. 4), pp. 85-86.

actions which should be taken to integrate and synchronize national policies in order to bring about this happy result.

Now we wish to consider the case of a country which has undertaken an expansionist policy while other countries do not fall into line and therefore finds itself in difficulties in balancing its international accounts. Its situation is exactly the same as in the case discussed in section 1 above in which a country is exposed to deflationary influences from abroad. Therefore the conclusions which we have reached regarding the preceding case apply also to the present one. It should use its international reserves pending recovery abroad. If this recovery fails to take place and the drain on its reserves tends to become permanent, it will of course be forced to take direct measures to alter the structure of its balance of payments.

It is, however, of the greatest importance to distinguish from the case just discussed that in which a fall in exports and a rise in imports is due to purely inflationary price rises at home. This is not only an important but also a difficult distinction, because a desirable expansion may develop gradually into inflation.

We have a clear case of inflation if after a high level of employment has been reached prices continue to rise. In such circumstances the country has failed to keep a stable level of activity and has started on an inflationary spiral which must be combatted. Unless its exchanges depreciate, it will suffer a consequential setback in exports which may prove to be a sufficient check to the inflation. If it is insufficient, then the special measures to check inflation that we have discussed in Chapters XII and XIV should be applied.

If inflation is allowed to go on for some time, the mere cessation of inflation will not be sufficient to stop the drain on the country's reserves. Prices at home and abroad will then have got out of line. In such cases an exchange depreciation, though necessary, may be inadequate and the country may have to face the problems of structural adaptation discussed in section 1 above.

In all circumstances the country suffering from a drop in its exports must consider with the greatest care whether that drop is due to mistakes or accidents abroad or mistakes or accidents at home. It would be well advised to assume, whenever the evidence is open to doubt, that the fault lies rather at home than abroad.

3. MONETARY IMPLICATIONS OF OFFSETTING POLICIES

Since the proposed policies are somewhat at variance with traditional practices, it is extremely important to be quite clear about their implications. At the risk of some repetition we wish therefore to draw attention to the two following points:

(1) We have argued that contra-cyclical policies designed to offset a cyclical drop in demand must be as concerned to prevent the spread of deflation abroad as they are to prevent its spread within the economy. This means that a country experiencing a cyclical set-back in its export markets should not counter the situation by seeking to cut its imports correspondingly. It should, rather, adopt measures to maintain its internal demand and should permit this demand to express itself in a maintenance of its imports. To do this will require larger reserves of gold or other internationally acceptable media of foreign exchange than was formerly considered necessary. It is to meet this type of need that the proposals for a monetary fund worked out at Bretton Woods have been formulated. Without sufficient international reserves to maintain imports during periods of cyclical recession, it is difficult to see how the cumulative international spread of depression can be avoided, or how any single country or small group of countries acting alone can combat internal depression without restricting imports and thereby intensifying depression abroad.

(2) We have argued that measures designed to interfere directly with the flow of foreign trade by reducing imports or expanding exports should be limited to situations in which a disequilibrium in the balance of payments is judged to be persistent, leading to a continuous drain on foreign reserves. Given these circumstances, a depreciation of the currency, limited to the amount necessary to restore exchange equilibrium, will produce less shock to international stability and less ultimate distortion in the world economy than the imposition of specific restrictions on imports. Sole reliance should, however, not be placed on currency depreciation to achieve structural adaptation. Depreciation should be regarded as supplementary to direct measures designed to increase either the efficiency of the export industries or the acceptability of their products, or, in cases where markets for certain exports are permanently lost, to measures designed to facilitate the adaptation of unemployed resources to new types of exports or to the provision

of substitutes for imported products. Frequently these direct measures of structural adaptation will be sufficient and depreciation or restriction in any form can be avoided.

We are aware that in practice situations may present themselves the diagnosis of which is extremely difficult, and others in which the application of these principles will depend on the policies adopted by other countries. Many of these situations are discussed in succeeding paragraphs of this Report. Many which cannot be commented upon in advance in the absence of specific knowledge of the relevant factors, will, we believe, lend themselves to diagnosis at the time in the spirit of the principles stated here.

4. FOREIGN INFLATIONARY INFLUENCES

Where inflationary influences from abroad make themselves felt the increase in exporters' incomes may give rise to an upward cumulative process, and if resources are already almost fully employed, this may cause an undesirable increase in prices, give rise to speculative activities and have disturbing and regressive effects on the distribution of income.

As before, the effects of the increased incomes of exporters may be offset by a corresponding decrease in domestic expenditure. Domestic credit expansion may be avoided by sterilizing part of the balance of payments surplus. Private expenditure may be reduced by credit restriction or taxation, and public expenditure may be curtailed in the hope of compensating gradually for the boom in the export industries. The balance of payments problem in this case is less urgent, since it involves an accretion instead of a loss of gold reserves. It is true that when the gold comes from reserves, one country's gain is another country's loss, and that the losing countries may have to take steps to stop the flow even if the gaining country need not do so. But if the surplus country is small and is absorbing gold from a number of larger countries, this check may not operate. The amount of gold each deficit country is losing may be unimportant, while the amount gained by the surplus country may be large in relation to its annual imports. If the surplus is due to long-term structural factors, the country may not wish to tie up a large and constantly increasing part of its assets in gold reserves.

In this case some structural adjustment of the balance of payments may be required; this may take the form of increased long-term lending, of relaxation of import restrictions, or of an appreciation of the currency. The last two methods, which operate on the current balance, also help to offset the increase in domestic expenditure and prices. By diverting some expenditure from the home market to imports, or by discouraging exports, they would tend to check the inflationary effects of the original rise in foreign demand. An increase in long-term foreign investment, though it would serve to offset the current surplus and thus produce an equilibrium in the balance of payments as a whole, would not necessarily exercise any offsetting influence on the national income. It may do so in certain circumstances, but when it does not a greater cut in domestic expenditure would be necessary to avoid inflation than if the balance of payments adjustment were effected in another way.

One of the rare examples of a deliberate adjustment of a balance of payments surplus was the appreciation of the Swedish crown undertaken during the first World War in order to check an unwanted inflow of gold. Most countries, however, have preferred to sterilize part of their gold imports, leaving their exchange rate unchanged; and when faced again with a surplus in 1936-37, the Swedish Government took steps to offset the inflationary effects by curtailing domestic expenditure, but undertook no structural adjustment of her balance of payments, so that gold continued to flow in.

5. DEFLATIONARY INFLUENCES AT HOME

If the inflow of gold into any country is due not to inflationary tendencies abroad but to deflationary tendencies at home, then clearly the appropriate policy to restore equilibrium is to stimulate domestic activity and raise the national income.

6. CONDITIONS FOR A SMOOTH-WORKING SYSTEM OF INTERNATIONAL PAYMENTS

The policies we have considered up to now have direct influence on the state of economic activity, not only in the country pursuing them, but in others. They are necessarily matters of international concern; and all national action to promote economic activity in a community of nations linked by international trade is a matter

of international concern.¹ It is necessary, therefore, to have some organ for the co-ordination of national policies and some mechanism for effecting international payments with a minimum of disturbance.

A smooth-working system of international payments should permit all countries, while maintaining a stable high level of employment at home, to meet payments due on international account without employing restrictive practices which impair the flow of multilateral trade.

We draw attention in Chapter XVIII to the dependence of many agricultural and mining countries upon foreign trade; but certain highly industrialized countries are scarcely less dependent. When capital goods constitute a large proportion of their exports these industrial countries are particularly susceptible to fluctuations in economic activity abroad. When in addition their imports consist largely of indispensable foodstuffs, their balance of payments becomes particularly vulnerable. Neither these countries nor certain of the smaller industrialized states with highly specialized export industries can hope to maintain a high and stable level of employment by means of domestic compensatory policies alone. It is therefore of vital importance to them, and indeed to the whole world, if standards of living are to be upheld or improved, that the volume of world trade should be maintained and that sudden changes in either the direction or the composition of that trade should be avoided. More than a mechanism to permit the smooth transfer of international payments is required. If depression and the spread of depression from market to market are to be obviated, there is need both for the will to maintain a high level of economic activity and income and for the will to maintain a multilateral system of trade in which all are able to participate under conditions at once equitable and stable.

We have dealt with the problem of commercial policy at some length in Part I of our Report, and refer to it again in Chapter

¹ Cf. the Resolution concerning social provisions in the peace settlement adopted at the International Labour Conference of 1944. The Preamble of this resolution declares that "the economic life and conditions in each nation are increasingly dependent upon the economic life and conditions of other nations"; and Article III places "opportunity for useful and regular employment" at the head of a list of "matters" which "are of international concern and should be among the social objectives of international as well as national policy". International Labour Office, *Official Bulletin*, vol. XXVI, No. 1, p. 79.

XX. We wish here to emphasize the fact that the imposition of trade restrictions or any structural changes adversely affecting important branches of trade are likely to impose shocks the repercussions of which will be felt not simply by the export interests immediately concerned, but throughout the whole trading community. Indeed, the maintenance of a smooth-functioning multi-lateral trading system is, in most countries, an absolute condition of the maintenance of a stable and high level of employment. On the assumption, therefore, that such a system is maintained, we may pass on to consider in greater detail its monetary prerequisites.

We have already suggested that countries should meet temporary deficits in their balances of payments by allowing an outflow of gold or other international means of payment. In order to render this possible, each country must be equipped with a reserve of international means of payment at least sufficient to meet such temporary discrepancies between receipts and expenditures on international account as are likely to occur. It does not matter exactly what form these reserves take. They may consist of gold, of liquid foreign assets, of an overdraft facility in some international clearing organization, or of the right to exchange domestic currency for the particular foreign currency required through some international stabilization fund; the essential point is that the reserve should be in some medium which is internationally acceptable.

Adequacy of reserves, as the Bretton Woods Conference recognized, is thus the first prerequisite for a working system of international payments. A second, equally important condition is the establishment of appropriate exchange rates. If a country has an overvalued currency and wishes nevertheless to keep its national income at a level corresponding to a high level of employment, its international reserves will soon be exhausted, and it will inevitably be driven into bilateral and restrictive trade practices, of which the experience of the nineteen-thirties furnishes ample illustration.

By appropriate exchange rates we mean rates which will secure long-run equilibrium in the balances of payments of all countries without imparting deflationary influences to any one of them. Such exchange rates would be appropriate to a situation in which all countries enjoyed a high level of employment without inflation.

It is clearly desirable that the rates of exchange should be fixed not by the uncoordinated action of individual countries, as was the practice throughout the inter-war period, but by common agreement. It is likewise desirable that subsequent changes in rates should not be made lightly, but only after careful consideration by all the parties concerned. The possibility of maintaining stable rates will depend largely on the policies pursued by major industrial states.

7. RESPONSIBILITY OF MAJOR INDUSTRIAL STATES

We must face the problem, therefore, of how to prevent maldistribution and depletion of reserves, if some important countries consistently allow their national incomes to fall so that widespread unemployment results. If economic conditions in a country of major industrial and hence trading importance are slack, its demand for foreign goods, particularly for the exports of the primary-producing countries, will drop, the incomes of these countries will decline. If they endeavour to maintain their imports, their reserves of gold and foreign assets will be depleted, and sooner or later they may be forced to devalue their currencies or to restrict imports by some more direct means. This situation is likely to be aggravated by the fact that major depressions in advanced industrial countries are usually accompanied by a cessation in their exports of capital.

The devastating effects of the depression in the United States, for instance, on international exchange reserves may be gathered from the fact that dollars supplied to the rest of the world (through imports and long-term foreign investments) fell from \$7,400 millions in 1929 to \$2,410 millions in 1932 (*i.e.*, by 67 per cent).¹ It would have been quite impossible for other countries to meet the drain arising from changes of these dimensions simply by allowing their international currency reserves to be depleted. In fact, losses of gold were accompanied or shortly followed in all countries by internal deflation, import restrictions or currency devaluation. How can the system of international payments and

¹ Cf. *The United States in the World Economy*, United States Department of Commerce, Economic Series, No. 23 (1943).

Merchandise imports plus other current payments fell from \$6,360 millions in 1929 to \$2,320 millions in 1932 (*i.e.*, by 64 per cent) and long-term foreign investment fell from \$1,040 millions to \$90 millions (*i.e.*, by 91 per cent).

multilateral trading be fortified to weather such shocks should they occur again in the future? Can the risk of such shocks occurring be reduced by international action?

8. CO-ORDINATED INTERNATIONAL ACTION

Up to a point, the existence of ample reserves of international currency in all countries should provide a buffer, enabling them to offset deflationary influences and preventing a depression from spreading beyond its country of origin. It is possible, however, that the reserves will not be sufficient to carry the other countries over until the depressed country has recovered.

In these circumstances, unless the country from which the depression is spreading appreciates its currency, three possible lines of policy would seem to present themselves to the other countries affected:

(i) these countries may simply suffer passively all the effects of the spread of depression which we have described above;

(ii) they may concert with the depressed country in order to work out a method by which that country may itself correct its balance of payments either by capital exports, or by an all-round stimulation of its economic activity;

(iii) they may endeavour to right their balance of payments, not in general, but as against the country which is causing the strain on their reserves.

The first course is equivalent to the absence of policy. The second is obviously to be preferred whenever it can be applied. It implies that constructive measures are adopted to remove the trouble at its source, not simply defensive measures against contagion. Moreover, it is clearly preferable whenever possible to concert, with the country from which the depressing influences spread, to take measures to revive activity and so check these influences before others have been compelled to suffer a loss of their reserves or to accentuate the risk of such loss by adopting autonomous measures to counter depression.

For these purposes an international organ for joint discussion and the co-ordination of policies will be required. This organ should be prepared at all times to put forward proposals for mitigating depressive influences, and when structural changes threaten to

cause depression, to submit plans for rendering those changes as innocuous as possible. These plans and proposals may relate to any part of economic life. There are no reasons for assuming that they will relate primarily to monetary policy. Indeed, that is improbable. The remedies required may be any of the types of policy that we have discussed in earlier chapters; they may demand action by one country only, or they may involve some far-reaching structural reorganization in which many countries will have to participate.

The third course mentioned above demands no less an international organ, for it implies some element of discrimination. If countries are to right their balances of payments against one other country only (or a small group of countries) they will be compelled to take special measures to check imports from or stimulate exports to that country either by tariff measures or by quantitative restrictions or by controlling operations in that country's currency. All these measures, if applied only to one country, or a restricted number of countries, are discriminatory, and if each country is free to decide when conditions have arisen justifying such action, the breakdown of international trade and of normal commercial relations is inevitable. Clearly in these conditions joint, agreed and formally regulated action is required. The need for such action is recognized in the scarce-currency clause of the International Monetary Fund Agreement.

Before such a policy is applied, every effort should have been made to work out, with the country from which deflationary influences emanate, means by which it may stimulate its economic activity and bring itself into line with the rest of the world.

Neither this nor any other policy adopted by third parties can bring about a revival of economic activity in a country which is reluctant to take the necessary measures. It is not intended, therefore, to cure the malady at its source. Indeed, it may accentuate the malady, because the discrimination against the exports of the country from which the depression is spreading will itself have a deflationary influence on that country. Nor is it an offsetting policy, in the sense that it substitutes a new demand for the gap caused by the reduction in those imports of this country which are required to meet its own domestic needs. What it can do is, first, to prevent the deflation arising in the country in question from

depleting the currency reserves of other countries and in this way initiating deflation there, and, secondly, to permit these countries to expand their trade *inter se* without the risk of loss of reserves arising on that account. These are results of major importance; but the policy will only be wholly successful if, owing to the joint pressure of this concerted discrimination, the country from which the depression is spreading is induced to adopt expansionary policies at home. On the other hand, it is clearly preferable to a generalized policy of obstructions to trade which is likely to be adopted, if the reserves of many countries are depleted owing to the failure of some country of major importance to maintain economic activity and if no specific action is taken either to persuade that country to stimulate its economic activity or to ward off the deflationary influences emanating from it.

9. CAPITAL MOVEMENTS

Balance of payments difficulties with all their repercussions may arise, not because of lack of equilibrium on current account, but because of movements of capital. It was not only disturbances in the current balance of payments arising out of depressions that caused the maldistribution of gold and led to the breakdown of the multilateral trading system in the 'thirties. Even more serious disturbances arose in the capital chapter of international accounts.

In the days of the gold standard, when the fixity and continuance of existing exchange rates were taken for granted, short-term capital movements were usually of an equilibrating kind. A rise in the discount rate and fall in the exchange rate within the gold points in a country with an adverse balance of payments would be the signal for an inflow of short-term funds, which relieved the need for an outflow of gold. But after the devaluation crisis brought on by the 1929-32 depression, confidence in the stability of exchange rates was destroyed. An adverse balance of payments came to be regarded as a prelude to devaluation and gave rise to an outflow of short-term capital of a disequilibrating kind, and political and personal insecurity greatly accentuated this tendency; capital flowed away from the country with an adverse balance and thus increased, instead of relieving, the loss of gold. The enormous flow of private funds to the United States between 1934 and 1939 was almost entirely of this disequilibrating type.

It is clear, as we stated in Part I of our Report, that in the transition period after the war "control over capital movements by means of an exchange control not designed to hamper the movement of goods will . . . prove indispensable in many countries".¹ It may be hoped that if adequate measures are taken to revive confidence in the maintenance of peace once it is won, if a satisfactory international monetary system is established with appropriate exchange rates, and if the major countries succeed in maintaining their national incomes at reasonable levels and co-operate to that end, the motive for disequilibrating capital movements will not again arise, and it will prove possible for countries to abandon their present controls over capital movements.

Nevertheless, should balance of payments disturbances again occur, as a result of political insecurity, badly chosen exchange rates, or inadequate anti-depression policies in some important countries, measures will certainly be required to check disequilibrating flights of hot money.

If effective checks can be obtained through controls less rigorous than supervision over all exchange transactions, we would prefer to see this course adopted, for exchange control necessarily involves expense and effort and may involve delay. If, however, the inducements causing short-term capital movements are strong, it is unlikely that these movements can be effectively controlled without an exhaustive supervision over all foreign exchange transactions; capital flight may be concealed in apparently innocent trading operations. We think it necessary, therefore, that countries which may in future find it necessary to reintroduce a system of exchange control should be fully conscious of the abuses to which such control may be subject and should take steps to guard against these abuses. We have in mind particularly the administrative use of exchange control machinery, ostensibly intended to control capital movements, for the purpose of interfering with current account transfers or discriminating against certain foreign markets. Exchange control after the transition period should, in our view, never be used for these purposes save with the express authorization of an international monetary authority, if one is established. Exchange control over current trading transactions,

¹ *The Transition from War to Peace Economy*, League of Nations, p. 88.

like the rate of exchange itself, is a matter of concern to all states, and, like exchange depreciation, is liable to prove contagious.

In other words, we view both exchange stability and freedom from the danger of the abuse of exchange control in any form as desiderata of policy, but we attach greater importance to exchange stability, because unstable exchanges are almost certain to have unsettling effects, while control of capital movements will only have serious unsettling effects if it is abused.

CHAPTER XVIII

NATIONAL ANTI-DEPRESSION MEASURES IN RAW MATERIAL AND FOOD PRODUCING COUNTRIES

1. CLASSES OF COUNTRIES CONSIDERED

It was explained in Chapter V that the problem of depressions in primary producing countries is in many ways different, both in its origin and in its manifestations, from that in industrial countries. We must now consider what special measures may be taken to mitigate the incidence of depression in these countries.

There are several distinct groups of non-industrial countries, which are somewhat differently affected by cyclical movements although they naturally shade into one another so that a clear-cut classification is not possible. Three groups may be distinguished here. The first group consists of agricultural countries with a low income per head, such as India and China and, to a lesser extent, parts of Eastern Europe, in which capital and in some cases land are relatively scarce compared with labour. This relative scarcity of capital and land keeps down productivity so that the majority of producers live at or near subsistence level. Only a relatively small proportion of production enters into the cash economy, and a still smaller proportion is available for export.

In consequence, this group of countries is somewhat less affected than the others we have to consider by depressions and booms in the outside world. To some extent it is affected; for a change in the price of export products, even when a small proportion of total output is exported, is likely to influence the prices of the whole amount of these products sold on the domestic market. This will in its turn reduce the income of the peasants and will increase the real burden of the debt of the individual producers; and the peasantry in these poorer countries is as a rule heavily indebted. But production, employment and even consumption may be only slightly affected. The major immediate influence of a depression on the peasants is thus financial, while the long-term influence may be permanently to lower their standard of living, owing to the fact that additional indebtedness is incurred during the period

of depressed prices. At the same time, such domestic industries as may be serving the local market may find the demand even for the most elementary necessities falling off to a much greater extent than in richer countries enjoying the benefits of social insurance. But the contribution of these industries to the total national income is small. The major cyclical problem here therefore is to maintain the money income of the peasant, and this is likely to be more important than the maintenance of exports.

There is in addition a long-term problem of vital importance, namely, that of increasing productivity by education and training of labour, by improving communications, by acquiring and utilizing productive equipment—the problem, that is, of raising the rate of investment, whether financed by domestic savings or by capital imports. Unemployment in the form in which it appears in industrial communities presents itself only to a very limited extent in these countries, though they usually contain a substantial amount of disguised unemployment in the form of superfluous labour on the farms, which could be released for industry or non-subsistence farming if capital were available to employ it. Both the cause and the remedy for such unemployment are different from those we have under consideration in relation to the business depressions with which we are concerned in this Report. The origin of the poverty and slow development in these countries lies in a shortage rather than an excess of savings; the large increase in investment needed to increase productivity requires either a curtailment of consumption or an import of capital; and curtailment of consumption in areas where the standard of living is already very low can hardly be effected save by compulsion and at the cost of serious hardship.

The second group of primary producing countries consists of countries such as Australia, New Zealand or the Argentine, in which land and capital per head of population are relatively abundant and the standard of living relatively high. These countries are largely dependent on outside markets, and are particularly sensitive to the effects of depressions in industrial countries on the demand for their exports, as well as on the flow of capital imports.

The depression problem in these countries centres round fluctuations in income received from their main exports and not simply

round the effect on total money income of a fall in export prices. As we saw in Chapter V, this income fluctuates mainly as a result of price movements and less through variations in the volume of output. In other words, the main problem for such countries is to prevent or compensate a deterioration in their terms of trade, or at least to mitigate the repercussions of such a deterioration on their national incomes.

The third group of countries consists of those, whether heavily populated or not, whose national income is largely dependent upon the export of minerals. In this group would fall, for instance, Bolivia, Burma, Colombia, Rhodesia, South Africa and Venezuela.

The depression problem of these countries is in many ways similar to that in the second group, but with this difference that their income derived from exports is likely to be influenced by changes both in the quantity and in the price of their exports. This phenomenon presents itself to some extent also in the case of certain agricultural countries exporting agricultural raw materials or semi-luxury goods—for instance, the rubber plantation and the tropical fruit states.

2. CAUSES OF DEPRESSIONS IN THESE CLASSES OF COUNTRIES

Short-term variations in the incomes of primary producers may arise from different causes. In the case of certain agricultural products, fluctuations in harvest yields due to climatic or other factors may affect the export proceeds; but the main cause of the price fluctuations of all primary products is likely to lie in the cyclical movements of national income in industrial countries and consequent sharp variations in their capital exports and in the demand for these products. As we have seen, these variations in demand are likely to influence the price and not the output of most agricultural products, and both the price and output of minerals. Views may differ regarding the respective importance of harvest variations and fluctuations in demand in causing cyclical depressions in agricultural countries. But since harvest variations affect only a few commodities, and in any case little can be done to prevent them, stabilization of income in industrial countries would contribute more than anything else towards preventing cyclical fluctuations in the incomes of the agriculturalists.

This stabilization of income would not only maintain their demand for crude products but also tend to assure a more even flow of capital exports. Wide variations both in the money income and in the balances of international accounts of the countries producing crude products would thus be prevented. Hence the policies discussed in earlier chapters designed to procure stability in industrial countries must be regarded at the same time as the main cure for cyclical depressions among primary producers. But industrial countries may fail to stabilize their business activity; and, even if they succeed, changes in demand for certain products may occur owing, for instance, to the development of some synthetic raw material, which may give rise to a structural depression in one country or another. We must consider then what measures may be taken by primary producing countries themselves to mitigate the impact of disturbances in their foreign balance on their economic life and whether joint measures can be designed between industrial states and primary producers which may help the latter—and possibly the former also.

We shall devote this chapter to national measures and deal with international action in the two following chapters.

3. DIVERSIFICATION

When a depression occurs in a country producing crude products owing to a permanent shift in demand away from one or more of its export products, structural changes will be required. The country has no alternative to adapting its production with or without foreign assistance to meet the changed conditions of demand. Structural changes may also be required in countries which specialize on one or a few staple commodities that constitute the bulk of its exports, if the demand for these products proves highly variable. A familiar method of attempting to mitigate the impact of recurrent depressions in these countries has been the diversification of productive activity with a view to reducing the risks attached to a "one-crop economy".¹ The diversification may take the form of promoting not only manufacturing industry, but also a greater variety of agricultural production. Proposals of this kind were discussed at the United Nations Conference on Food and Agriculture, held at Hot Springs, Virginia, in the early sum-

¹ Cf. *Review of World Trade, 1937* (League of Nations, 1938. II.A.5), pp. 73, 75.

mer of 1943. But this is a long-term policy which cannot, of course, be employed to avert a specific threatened depression. In the absence of such structural changes, what measures can the primary producing countries take to mitigate or avoid depression? Such measures may be directed either towards assisting the particular producers concerned by means of export subsidies, debt relief etc., or towards maintaining the level of national income as a whole.

4. EXPORT SUBSIDIES, GUARANTEED PRICES AND GOVERNMENT PURCHASE SCHEMES

One means which has frequently been adopted to mitigate fluctuations in the incomes of exporters is the payment of export subsidies during depressions. Such subsidies, which for reasons we explain below we do not advocate, are likely to exercise their maximum stabilizing influence if supplemented by export taxes when prices are high and financed by borrowing, the tax receipts being used for debt repayment. These subsidies have exactly the opposite effect to that of an export tax in that they tend to keep up the price of the products sold at home. They are likely to prove less costly, therefore, when the proportion of the total domestic production exported is small—the first group of countries mentioned above. Partly for this reason, no doubt, a number of countries have had recourse to government purchase schemes. Under such schemes the government buys the products at a fixed price, itself bearing the loss or reaping the profit due to the deficiency or excess of the world price over the price paid.

Such a scheme was introduced in New Zealand under the Primary Products Marketing Act of May 1936. The Act was in fact applied only to dairy products. The Government assumed ownership of all butter and cheese for export, for which farmers were paid fixed prices. Domestic sales were regulated with a view to keeping prices on the home market in line with the guaranteed export prices. The theory behind the scheme was that the profits earned when world prices were above the guaranteed price would serve to cover deficits incurred when world prices were low. The scheme was thus intended to be self-financing in the long run, temporary deficits being covered by advances from the Reserve Bank. At the same time, however, prices were supposed to afford “a reasonable state of comfort” to efficient producers. This criterion in the period up to the outbreak of the war proved more

important than that of financial self-sufficiency. In fact, during the three years up to that date, there was a general tendency for the fixed price to rise, and although world prices were rising also, there was a surplus of £550,000 in the season 1937/8 but a net deficit for the three seasons of £1,000,000.

Guaranteed prices for a number of agricultural commodities—wheat, rye, butter, cheese, eggs, bacon and wool—existed also in Estonia. In the case of eggs and bacon, the market prices rose at times above the guaranteed price, yielding a profit for the special fund that was created. In other cases prices had to be continuously subsidized from the fund.

In the Argentine guaranteed prices for wheat, linseed and maize were administered by the Grain Regulating Board created in 1933. The Board undertook to purchase any of these commodities to any extent necessary whenever market prices fell below the guaranteed minimum. The costs of administration and losses on these transactions were financed from the profits arising out of the difference between the buying and selling price of foreign exchange. When world prices were above the guaranteed minimum (*e.g.*, wheat in 1934/5, linseed in 1936/8), the Grain Regulating Board ceased operations, so that its own activities operated only as a subsidy and not as a tax. The tax—in the form of the profits of the foreign exchange fund—fell on imports and exports generally.

Similarly, the wheat and rye monopoly operated by the Cereals Purchase and Export Administration in Bulgaria was used to subsidize prices of these commodities. Any profits were shared *pro rata* among the growers, while losses were covered by the State. The Cereals Purchase and Export Administration was also authorized to buy at fixed prices a number of other commodities—rice, tobacco, hemp, flax—in which there was no State monopoly.

Frequently these guaranteed price schemes are coupled with some form of subsidy, the government either exporting itself at a loss or granting a subsidy to private exporters so as to reduce its own stock holdings.

Experience shows that in practice the guaranteed price tends to be fixed at too high a level, so that the burden of the subsidy in depressions is never fully offset by taxes during booms. Apart from this practical objection, however, such schemes have a serious

disadvantage in principle. If they are enforced and the government does not simply accumulate stocks, they stimulate exports when prices are low and penalize them when prices are high, thereby tending not only to accentuate price fluctuations in the world market but also, over a period of good and bad years, to reduce the average income from exports. For this reason an export subsidy and tax policy, though it may well help to reduce fluctuations in producers' incomes, is definitely inferior to an international policy of buffer stocks or even to a contra-cyclical stock policy pursued by a single government and operated without the aid of a subsidy. But stock piles accumulated by a single government are liable to stimulate the production of what is already in excess and to grow until they rather threaten than support the market. They constitute, moreover, a very difficult financial undertaking when the proportion of the total crop exported is large, and would involve even more serious risks in the case of minerals, the output of which can be easily and may be suddenly increased.

Subsidies in our opinion are open to the strongest objection on grounds of commercial policy. They constitute a means by which one government endeavours to promote its trade at the expense of other countries. They involve, therefore, the risk of tempting other governments to grant subsidies in their turn or to impose special restrictions against the countries granting them. In the one case they defeat their own purpose directly and involve governments in useless expenditure; in the other they defeat their own purpose indirectly by leading to a blocking of the channels of trade.

5. DEBT ALLEVIATION

A factor which tends to accentuate the fluctuations in incomes of agricultural producers resulting from price changes is the peculiar rigidity of their capital costs. Apart from self-financing, investment in agriculture is nearly always financed by debt. Yet agriculture of all industries is the least suitable for financing by fixed and rigid claims on money. It is subject to the vagaries of the weather, and it is subject to exceptionally violent price movements. Financing predominantly by debt thus aggravates the hardships inflicted by cyclical demand and price fluctuations.

One way of mitigating fluctuations in farmers' incomes is therefore to reduce the rigidity of agricultural debt, to make the con-

ditions of financing more flexible as regards both interest and amortization. For long-term government and commercial debts, some flexibility is provided by the possibility of reducing interest charges through conversion operations. This element of flexibility may be insufficient for agriculture, but it is clearly advisable to make the fullest possible use of it whenever conditions in the capital market are propitious.

Bank loans normally play a specially important part in agricultural debt structure. It is a practice in some agricultural countries for the central bank to grant direct loans and discounts to a wide circle of private customers. When this is the case, owing to the central bank's competition with the commercial banks, changes in the bank rate may have both a direct and an indirect influence on the cost of credit. In all circumstances central banks in agricultural countries should be encouraged to influence the short-term interest rate by varying their own discount rate and by other means at their disposal, so as to make farmers' interest charges on working capital more flexible when prices change.

As regards long-term mortgage debt, the depression of the early 1930's was marked by drastic and far-reaching debt relief measures in practically all agricultural States. That depression, as measured by the fall in agricultural prices, was of exceptional severity; but so long as prices continue to fluctuate widely, compulsory conversions and moratoria are likely to recur in times of depression. These measures, however, upset confidence. It might be preferable to regularize the position and to recognize in the legal instruments of financing the peculiar economic vulnerability of agriculture.

The most suitable measures to adopt to this end would depend on local conditions; but we may mention one or two examples which illustrate the type of policy that could be adopted. In Denmark in 1931 the Government made advances to farmers to assist them in making settlements with their creditors; the settlements involved repayment of 35 per cent of the debt on condition that the interest on the remainder, which was subject to moratorium, should vary with the price of butter and bacon. More important was the law of 1933, which provided that small farmers settled and financed by the State should have the option of paying interest varying with economic conditions instead of at a fixed rate. The

variable interest was based on the prices of butter, bacon, and barley. A fall in the price of these commodities was at once reflected in a fall of interest charges. In 1938 the system was modified to give the small farmers the option of having their interest payments based on their incomes, instead of on the prices of their products.

In the examples quoted above the creditor is the State. The same principle, however, of variable farm mortgages has been used on a considerable scale in private farm financing in certain parts of the United States and Canada. The main instrument used is a crop-share agreement. Such agreements take many forms, but the characteristic feature is that the annual service of the debt is represented by a specified share of the crop. The amount of money produced by the delivery of the agreed share of the crop is credited first to interest and then to amortization account until the debt has been completely paid off. This provides flexibility as to the timing of the repayments of the principal.

It should perhaps be stressed once more that the burden of agricultural debt becomes a problem mainly as a result of the instability of agricultural prices. The fundamental solution must lie in greater stability of prices; it is only in so far as this is not achieved that modification of the debt structure and other such palliatives become necessary.

6. MONETARY STABILIZATION

We described the broad lines of the banking and monetary policies we advocate in Chapters XI and XVII, and explained how expansion or contraction of credit and therefore of national money incomes may be influenced either by means of the rediscount rate of the central bank or by modifying from time to time the reserve requirements of the commercial banks or by some form of open-market operations.

In many agricultural countries, however, conditions have not been favourable for such operations, and it is in our opinion important that the difficulties which have presented themselves should be overcome. The most important of these difficulties are three:

- (i) The central banks have frequently had little influence over

the domestic market because that market has really been dependent not on it but on some foreign money markets. When conditions are favourable borrowing abroad by both commercial banks and industrial and commercial firms has been easy, and the domestic central bank could not hope either by its discount rate or by the sale of securities effectively to check the consequent expansion of credit;

(ii) The absence of an adequate domestic market for the securities appropriate for open-market operations;

(iii) The fact that many central banks did not own sufficient of the type of assets that might have found a market.

We have already dealt in Chapter XVII with the international movement of short-term funds and need not therefore expand here on this point. We anticipate that the difficulty of making the central banks' discount rate effective, caused by the fact that commercial banks and trading firms in many non-industrial countries depend largely on foreign capital markets, will in any case diminish in the future. But, however that may be, it would be lessened were the central bank to insist, as we consider it should, on obtaining full and regular information concerning all foreign credit operations.

We doubt, however, whether discount policy alone will be sufficient to check an inflationary secondary expansion of credit during a period of great export activity or to revive credit when exports fall off. The difficulties we have just mentioned in connection with open-market operations in the countries we are considering cannot therefore be overlooked. In these countries the commercial banks themselves are likely to constitute the most important market for the conduct of open-market operations and they are as a whole large holders of government securities. They may be reluctant to add to their holdings of such securities when business is active, but at the same time, on account of their existing holdings, they have a direct interest in preventing a fall in the price of such securities. A system of open-market operations which increased their chances of disposing of such securities to the central bank during times of adversity would, therefore, be greatly to their advantage. In the past the difficulty has indeed been rather that the central bank lacked an adequate stock of suitable securities

than that the commercial banks would have been unwilling to purchase. The reason for this fact has been that governments have unfortunately so frequently borrowed from the central banks on some form of ways-and-means advances rather than by the sale of ordinary treasury bills or long-term securities. What is necessary is that part of this dead-weight government debt of the central banks should be converted into saleable securities. This would, of course, impose some additional interest burden on the governments; but that additional charge would, in our opinion, be negligible compared with the loss of revenue resulting from falling prices. When under the statutes of the national banks all profits in excess of a fixed amount revert to the state, the additional charge may prove to be very small. In addition to this, the central banks in certain countries will no doubt find it necessary to improve the organization of the market, which may prove difficult when the market is small and dominated by one or two commercial banks.

A striking demonstration of the type of offsetting policy appropriate to a country producing primary products was given by the Argentine after the establishment of the Banco Central in 1935. From that year to the middle of 1937 the country experienced both a considerable rise in the prices of its export products and a substantial inflow of floating funds. After the middle of 1937 there was a severe fall in export prices and a precipitate outflow of foreign capital. These movements—large and sudden enough by themselves—were further accentuated by the weather: after a bumper crop in 1936/7, which could be sold at high prices, a very poor one came in 1937/8, which fetched abnormally low prices. But the repercussions of these changes on the domestic credit situation were surprisingly moderate, owing to the policy of monetary neutralization.¹ In the earlier part of the period, coinciding with the cyclical upswing, the Argentine banking authorities “absorbed” the inflow of foreign exchange. In April 1937 the total holdings of gold and exchange sterilized by these methods were as large as the reserve held by the Bank in 1935.

¹ For a full description of this policy see the *Annual Reports* of the Banco Central de la República Argentina, especially that for 1938, which in Part II (“The Trade Cycle and Monetary Policy”) and Part III (“Monetary Absorption and the Problem of the Cycle”) contains a valuable discussion of the general problems involved.

"The conversion of those holdings into banknotes would, therefore, have doubled the total note issue."^{1,2}

The monetary "offsetting policy" just mentioned has a two-fold function. Its internal function is to check inflationary and deflationary movements in domestic business activity arising from variations in the proceeds obtained from exports or fluctuations in the flow of foreign capital. Its external function is no less important, namely, to build up a reserve of international means of payment when export prices are high. When export prices fall, this reserve can be drawn upon to keep up the volume of imports and hence the real income of the country. The importance of an adequate international reserve is obvious—and has, indeed, been generally recognized—in countries whose products are subject to wide price fluctuations. The need for such a reserve would be all the greater if any country managed to maintain its price level more stable than other countries during a depression by open-

¹ Banco Central de la República Argentina: *Annual Report for 1938*, page 19.

² Three methods were used to absorb the inflow of foreign exchange:

- (i) open market sales of securities;
- (ii) utilization of the idle resources of the Exchange Fund;
- (iii) changes in the official rate for the sale of exchange and intervention in the free-exchange market.

The first two methods led to the withdrawal of surplus funds from the commercial banks and to the accumulation of gold and foreign exchange in the hands of the Central Bank for its own account, that of the Government and of the commercial banks. The Central Bank had been initially entrusted with four hundred million pesos worth of Consolidated Bonds of the National Treasury for the exercise of its open-market operations. These funds corresponded to the balance of securities deposited formerly with the Caja de Conversion and the Banco de la Nacion. When the original fund was approaching exhaustion at the end of 1936, the Government created one hundred million pesos of Special Bills to be placed with the commercial banks in the same way as the certificates of participation in the Consolidated Bonds of the Central Bank. The bills were quite distinct from the tender bills issued to meet current Treasury expenses. As the influx of foreign funds continued, the Central Bank decided in March 1937 to issue Gold and Foreign Exchange Holding Certificates to be placed and used in the same way; the gold and foreign exchange acquired in this way was entered into a special account, which did not affect the reserve of the Central Bank or the cash resources of the commercial banks. Finally, the idle resources of the Exchange Fund—derived from the profits on foreign exchange transactions, from the sale of bonds and other idle Treasury balances—were used to buy exchange from the banks.

A substantial part of the gold and exchange resources acquired by these various means was used for repatriation of the foreign debt.

Thanks to the so-called "absorption policy", the expansion of credit was not excessive. In the succeeding recession the offsetting mechanism was reversed. The policy "undoubtedly assisted in keeping internal trade at a comparatively high level in relation to the heavy fall in exports" (Banco Central: *Annual Report for 1938*, page 22).

market operations or other means, for its competitive power on foreign markets would be reduced.

7. DEVALUATION

Owing on the one hand to the fact that agricultural and mining countries have not as a rule accumulated very large currency reserves, and on the other to the exceptionally wide changes which take place in their balances of payments, these countries have in the past frequently felt compelled to meet the pressure of a fall in the price of their exports by devaluing their currency. The first effect of devaluation is to help to maintain national income in terms of domestic currency; for even if the lower price of the exports of the devaluing country in terms of foreign currency does not lead to any considerable increase in the demand for these exports, the exporters will nevertheless obtain a larger sum in terms of domestic currency for each unit of quantity sold. At the same time, imports become more expensive to the nationals of the country in question, which will afford some stimulus to domestic manufacturing.

But, although exchange depreciation has been frequently adopted as a method of meeting depressions in primary producing countries, it has a number of serious disadvantages. First, like subsidies, it is liable to prove contagious. Both devaluation and subsidies are means by which one country may obtain an advantage in international trade at the expense of others. In both cases the countries thus placed at a disadvantage are likely to defend themselves either by pursuing a similar policy or by imposing restrictions on imports. When this happens, the terms of trade of the producers of primary products may be rendered still more unfavourable by the widespread competitive pressure on the prices of their exports. If these countries are, as they frequently are, debtors on foreign account, they will then find the burden of their foreign debt increased, perhaps to breaking point. Moreover, currency depreciation tends to give rise to speculative capital export, a tendency which is all the stronger because agricultural countries which depreciate their currencies in bad times very rarely raise them again in good times.

In the absence, however, of some international organ which may render aid in difficult times, such as was proposed at the recent

Bretton Woods Conference, for a country depending on only a few export products whose prices are highly variable, absolute fixity of exchanges may not be a practicable policy. This view has been expressed to the Delegation in certain memoranda furnished to it by governments, and also by the Australian Royal Commission on Monetary and Banking Systems in 1937. "The policy is not to fix the exchange rate and require the economy in ordinary circumstances to adjust itself to that rate, but to keep the economy reasonably stable and to move the exchange rate, if necessary, as one means to that end."¹

8. EXCHANGE CONTROL

An alternative to immediate exchange depreciation is the imposition of exchange control. By this means domestic income may be maintained, while imports are kept within the limits dictated by the decreased supply of foreign exchange from exports. But exchange control, if it is used to protect the domestic price level, severs the price relationship between the country imposing it and the rest of the world, which exchange depreciation does not. Exports are impeded by the maintenance of the domestic price level, which is not offset by a reduction in the exchange rate, and imports are stimulated by the price conditions created, though they may be checked by the exchange rationing. The balance of trade is consequently adversely affected, and equilibrium can only be restored by prices abroad rising to the level maintained in the country imposing the control. Experience has shown that this generally does not happen, but, on the contrary, as world prices rise, prices in the controlling country rise also. Consequently, it becomes impossible for this country to abolish its control without devaluing its currency. In these circumstances exchange control does not prove an alternative to devaluation but only a delaying action. During the period of this delay, which may prove protracted because vested interests grow up behind the control, international trade is hampered with depressing effects upon national standards of living.

9. THE INADEQUACY OF NATIONAL MEASURES

From what has been said it would seem to be clear that there is

¹ Commonwealth of Australia, *Report of the Royal Commission to inquire into the Monetary and Banking Systems at present in operation in Australia*, 1937, p. 204.

no satisfactory means by which these countries, acting alone, can avert depressions, though they may to some extent mitigate them. In many cases this can only be done by adversely affecting other countries. Therefore a satisfactory solution can only be found in some such concerted international action as we discuss in the next two chapters.

CHAPTER XIX

INTERNATIONAL ANTI-DEPRESSION MEASURES FOR RAW MATERIAL AND FOOD PRODUCING COUNTRIES

Attention has been drawn in the last chapter to the fact that the money incomes of countries producing crude products were liable to exceptionally wide variations owing, first, to cyclical variations in the foreign demand for those products, and, secondly, to parallel variations in international capital movements. We have shown that domestic policies for maintaining money income in these countries, however necessary they may be, are likely to prove of limited efficacy and that, unless some other means can be devised to aid them, these countries are likely to be very largely dependent on the success with which co-ordinated policies in the greater industrial states can be carried out. We have already suggested that the International Bank for Reconstruction and Development and other official financial institutions might make a contribution to world economic stability by pursuing, as far as possible, a contra-cyclical investment policy. We wish now to consider whether additional international machinery could not be devised by governments with a view at once to setting limits to the price fluctuations of crude products and to diminishing the effects of any variations in private international capital movements. Were this possible, then the fluctuations in the money incomes of the countries producing raw materials and foodstuffs would be reduced and at the same time the demand of these countries and, indeed, of agriculturalists and miners generally for manufactured goods would be better maintained, with the result that employment in industrial countries could be kept active.

1. BUFFER STOCKS

In discussing the various types of stockholding in Chapter V, we found that certain policies exercised a stabilizing influence on prices, while others had the contrary effect. Holding back of supplies in case of a bumper crop, or meeting a temporary increase in demand out of stocks were seen to be stabilizing influences, whereas purchasing of stocks during periods of rising prices in anticipa-

tion of a further rise, and corresponding bear operations during falling prices, were seen to be destabilizing influences. These observations suggest that an attempt might be made deliberately to reinforce the stabilizing type of stock policies in order to counteract and outweigh the effects of the destabilizing type.

Manufacturers, retail distributors, etc., reduce their stock holdings when activity declines for two reasons: first, because they anticipate that prices, already probably declining, will decline more, and secondly, because they require smaller stocks for a smaller turnover. If stocks were held in strong hands capable of preventing a very large decline in prices, then the first motive for the reduction of manufacturers, stocks would be weakened, and visible stocks would show narrower movements and would no longer constitute a bearish influence on the market. We are glad to note, therefore, that plans have been discussed for the constitution and financing of an international buffer stock agency with the function of purchasing crude products when their prices tend to fall and selling them when their prices tend to rise.

The very knowledge that buffer stocks exist, however, may have a depressing influence on prices, unless the market has absolute confidence not only in the financial strength of the buffer agency, but also in its determination not to release the stocks until the price has risen to a fairly high level. To create such confidence, it is necessary that:

- (i) the stocks should have a financial backing of strength adequate to ban any speculation on its breakdown;
- (ii) they should be so large as to preclude speculation on their exhaustion;
- (iii) they should be subject to a determined policy of price stability and not of maximum profits.

In order to meet these conditions, it would be necessary that governments should constitute a fund to be placed at the disposition of a buffer stock agency. This agency should be prepared to buy unlimited quantities of the commodities in which it dealt at, but not above, predetermined minimum prices, and to sell freely at, but not below, predetermined maximum prices. It might, for instance, take as its standard the average price for the preceding eight to ten years and announce that it is prepared (1) to buy any quantity when the market price falls to, say, 20 per cent below

the standard price, and (2) to sell when the price rises to 20 per cent above the standard. Under such an arrangement prices might fluctuate 20 per cent above or below a given level but not more. If that level were a moving average it would tend to adjust itself to long-run changes in demand and supply. Even so wide a margin would represent a great advance towards stability over past experience. But the figure of 20 per cent is only taken as illustrative. In practice, (a) different margins would probably have to be adopted for different commodities, according to the elasticities of demand and supply, and (b) the maxima and minima could not be fixed for all time. Variations of the maximum and minimum prices would be required whenever stocks tended to accumulate over any considerable series of years because the maximum was too high or to vanish because the minimum was too low. For buffer stocks to operate successfully, the mean price should be such as to adjust production to demand over the period of the cycle.

Cycles, however, vary in length, and over any period of years the average relative values of commodities change not only for cyclical reasons but on account of longer-term changes in demand and supply. For this reason the prices offered by the buffer stock agency should not be unalterable, but should reflect changes in long-run conditions. Otherwise excessive stocks of some goods would accumulate and the stocks of others would tend toward zero; the buffer stock system would have failed to reflect relative changes in demand. These facts constitute the central difficulty, which can only be overcome by modifying the maximum and minimum prices from time to time. What is necessary, therefore, is that the buffer stock agency should so administer the system as to give it a sufficient elasticity to avoid waste and sufficient rigidity to assure confidence in the prices offered. Confidence, we believe, would be best assured were governments to lay down certain principles in their articles of agreement rendering the operations of this agency as automatic as the need for the occasional modification of the basic prices may permit.

If, as we hope, it proves possible to establish such an agency it should, in our opinion, be international and not national and should be formed by governments of both producer and consumer countries. Buffer stocks administered by the producers only are, for the reasons we have given, not likely to create sufficient confidence

to assure price stability, though they may do so when the individual producers are small in number and financially strong. They would also tend to reflect the producers' interests rather than those of all parties.

In agriculture the unit of production, the farm, is generally small and contributes a very small proportion of the total world supply, so that farmers do not as a rule have sufficient financial resources to operate their own buffer stock scheme. Apart from financial difficulties, however, there are objections in principle to the operation of buffer stock schemes solely by producers. It is difficult for the producer to resist the temptation to fix prices too high, and impossible for him to avoid the accusation that he is so doing. If prices are too high stocks will accumulate and lead to a breakdown of the scheme or to restriction of output. Even in the case of those minerals the producers of which are strong financially and few in number, it is therefore preferable that equalization stocks should be organized on a broader basis.

The danger of prices being fixed too high might also arise were the agency to be established by the governments of only the producing countries. Moreover, were this done, the scheme would fail to promote a flow of funds from the industrial to the agricultural and mining states during a period of depressions, which is one of the objects we have especially in mind. The agency should be constituted therefore by governments of both producing and consuming states, and it should be entitled to raise funds in addition to its initial capital wherever market conditions were most favourable. As funds are likely to be abundant in exactly those industrial states which are suffering from inactive business conditions and causing depression to spread elsewhere, the expenditure of these funds would help to restore the flow of capital from areas in which savings are going to waste to areas in which money income is being reduced in part owing to scarcity of funds.

The immediate financial problem to the countries consuming crude products—the countries on whose markets the bulk of the funds are likely to be raised—will, we believe, be of much less importance to them than the maintenance of the demand, by the countries producing raw products, for the industrial exports of the countries consuming raw products. Moreover, it may well be that the industrial countries consuming crude products will secure their

imports more cheaply on the average over the whole period of the cycle.

Were such a system established, it might prove wise to limit it initially to the more important storable commodities, and as experience is gained, to extend it over a wider range of goods in order to exercise a greater influence and in order to diminish the risk of causing disturbing shifts in production. The farmer can, within limits, turn from one crop to another; if prices of too few commodities are stabilized he may divert production in favour of these stabilized commodities in the depression and turn to others in the boom. But such a scheme could only be applied to goods which can be easily stored for a considerable period of time at a cost which would not involve the agency in financial loss. It is obvious that the margin between buying and selling prices must be greater than the cost of storage during the average period of storage, if heavy financial loss is to be avoided.

A buffer stock scheme is not, of course, intended to earn profits; on the other hand, it is important that it should be administered with a view to avoiding loss. The deliberate accumulation of stocks during depressions constitutes an act of investment which tends to stimulate activity in a manner precisely analogous to any other type of investment, such as, for example, public works. It is, however, we believe, a form of investment peculiarly well adapted to deal with the depression problems of primary producers. In the first place, it serves to maintain their purchasing power without necessitating shifts in productive activity such as are normally associated with public works. Secondly, it helps to maintain a balanced structure of prices. Thirdly, in so far as the buffer stocks are financed by the advanced industrial countries which are normally exporters of capital, it mitigates the disturbances in balances of payments due to the simultaneous decline in capital exports and commodity imports which are usually associated with a depression in these countries. Finally, owing to the maintenance of the purchasing power of the producers of crude products, not only in the countries specializing in such products, but throughout the world, the demand for industrial goods will likewise be maintained and employment in manufacturing industries kept active.

We are fully conscious of the practical and political difficulties of carrying out the type of policy suggested above. It is not easy

to estimate the trend of demand; it is impossible to foresee the fluctuations of the weather. Errors of judgment will be inevitable, and the conflict of interested parties may threaten to undermine the working of the scheme. On the other hand, it happens that the administrative machinery and technical storage facilities built up to accommodate and handle stocks of basic commodities during the present war offer an unusually favourable opportunity for the introduction of such schemes on the return to peace. The recollection of the effects of the violent instability of prices of primary commodities in the pre-war decade should predispose all parties concerned in favour of any scheme that offers some hope of mitigating this evil.

The main objections currently raised against buffer stock proposals are: (1) the cost of financing them, (2) the risk of losses in storage and (3) the risk of the guaranteed prices leading to (or at least failing to avert) overproduction. Obviously, on the question of cost, governments must decide what price they are prepared to pay for economic stability and the avoidance of depressions. Stocks have in any case to be financed by the community. If the price of goods is allowed to slump, the financial cost of carrying them is lower and the real loss by the community in the disruption of trade, the disemployment of men and machines and the loss and destruction of large quantities of crude products is infinitely greater. Similarly, the risk of loss in storage is real; but it is much less than the risk of loss of, for instance, agricultural products rotting in the rick. But the risk of overproduction is a serious one. We have already commented on it and emphasized the fact that it necessitates the most careful price policy. The relative average prices of certain products in the recent past may be a convenient approximation to begin with. But in the course of time the closest attention will have to be paid to the standard price. The success of any buffer stock scheme will be determined by the wise determination of the standard price.

Quite apart from the level at which the standard price is fixed, the buffer stock agency may be involved in unnecessarily large financial commitments in cases where countries are operating their domestic policies, through export subsidies or otherwise, in such a way as to increase domestic production and reduce domestic consumption. Where such policies materially affect the quantities

available for export, the buffer stock agency would have to retain the liberty to limit purchases from such countries.

2. PRODUCTION CONTROL

It is partly because of doubts concerning the possibility of avoiding overproduction simply through the mechanism of price that direct control of output is advocated in so many countries and has so frequently been attempted. But the distinction between buffer stocks and production control is not simply that one operates through the price mechanism and the other directly on production. Buffer stocks are an instrument for limiting certain effects of cyclical influences; production control is a means for limiting certain effects of long-term or structural tendencies.

Before examining general principles, it may be well to point to the difficulties which the application of control is liable to meet in practice. In agriculture, at any rate, the number of independent producers is far too great to permit of production control by voluntary action. Compulsion by governments raises thorny problems both of domestic administration and of international agreement. In all cases—even where voluntary agreement among producers is technically possible, as it not infrequently is for minerals—it is difficult to reconcile the interests of producers with widely varying standards of efficiency and production costs; the natural opposition between low-cost and high-cost producers has been a constant source of trouble in the working of production control schemes and has often caused their breakdown. Furthermore, it is not always possible to get all individual producers or all producing countries to join a given scheme. Production control tends to favour those who remain outside. They are given an opportunity to expand their output, and their competition may eventually become strong enough to defeat the scheme.

Notwithstanding these difficulties, production control schemes are constantly advocated and enforced, and no sooner does one collapse than another is planned and for a time executed. More recent schemes have no doubt benefited from past experience. We need not concern ourselves, however, with the questions how far these schemes were successful or were required in the absence of buffer stocks. But how far would they be necessary to prevent overproduction were an effective buffer stock scheme in action?

If the force of competition were allowed by the exercise of its natural influence to eliminate the less efficient producers, there can be no doubt that the need for them would be limited, for in these circumstances the managers of the buffer stocks could generally avoid the risk of being compelled to accumulate abnormal and excessively expensive stocks by reducing the prices they offered to a point at which redundant producers were eliminated. Conditions may arise, even under free competition and the effective operation of the profit system, under which this would not happen or would only happen at an unreasonable cost to the whole community of producers. We will revert to these exceptional conditions shortly. Before doing so we must take cognizance of the fact that productive capacity is not in practice quickly eliminated when redundant. There are, indeed, two serious difficulties.

The first of these difficulties is the natural reluctance of agriculturalists to abandon their farms simply because they have ceased to make a profit. To do so means much more than the surrender of an unprofitable undertaking. In most cases it involves the surrender of all hope of continuing the independent form of life to which they are accustomed and attached, and a forlorn search for dependent work for which they are not trained and for which they may have but little desire. Granted they can support themselves, however meanly, by their own produce, they are likely to continue to cultivate their land and sell something off the land for a very long time.

The second is the unwillingness of governments to allow any producing community, whether of farmers, planters or miners, to be eliminated by foreign or even by domestic competition. Before this happens they are likely to afford such communities support in the form of subsidies and tariffs, of debt and tax relief; they are likely to give direct or indirect aid to dumping; they are likely themselves to enter the market and buy at a cost that is never subsequently covered.

Owing to the first of these two difficulties we must accept the fact that an international buffer stock agency might have to carry stocks in excess of what would be required to smooth out cyclical price movements for a quite considerable time, and since the total value of the marketable production of certain of the major staple crops is very great, the financial costs involved might be serious.

Within limits the farmer is more concerned with security than with the breadth of the profit margin. Security is afforded by fixing prices, and the buffer stock agency *ex hypothesi* could not modify its price limits very frequently or widely. In our opinion, therefore, while it would be always preferable to operate through buffer stocks alone when possible, and especially through changes in the prices offered by the agency for one crop or another, we must admit that supplementary production control schemes may be required. We must accept them not as an obvious instrument, but as a last resort of policy.

The second difficulty is similar in kind, though much wider in its implications than the first. It affords a quite different justification for production control. That justification is that such control may prove necessary as a supplement to buffer stocks in order to preserve the existing pattern of production and productive capacity in the world rather by international agreement than by competition among governments in the preservation of redundant capacity. The justification is only valid so long as governments are resolved to prevent the elimination of the unprofitable. The creation of a buffer stock scheme would remove an important reason for protectionism, because, as we shall show immediately, it would very greatly diminish, if not remove altogether, what has been a real risk in the past, namely, that productive capacity which is again vitally requisite during a boom may be destroyed during a depression. But in spite of this fact, it would be unrealistic to assume that governments will in the future always be willing to abandon what is genuinely, in bad times and good times alike, surplus capacity, and, failing that assumption, concerted control may prove preferable to a haphazard struggle for survival.

But it is important that governments should realize that, quite exceptional circumstances apart, the risk of valuable productive capacity being destroyed during a depression would be greatly reduced by a buffer stock scheme. For an essential purpose of the buffer stock agency is to prevent prices falling during a depression to those disastrous levels which devastate and destroy. We have in mind particularly the somewhat exceptional risks which the mining industry has to face. It is always possible that a new and exceptionally rich mine may be discovered and rendered profitable by improvements in transport, which for a time would

render impossible the profitable operations of older mines whose surface production has already been creamed. The risk is particularly grave in the case of those minerals the world production of which is neither very great nor very widespread. In the face of such a risk, buffer stocks may prove inadequate. To sacrifice the older mines which may be required again once the more accessible seams of the new mines have become exhausted, is likely to be uneconomic, even were it practicable; to purchase all the amounts necessary to keep them in operation in spite of this new competition may be both financially and economically extravagant. International agreement concerning the control of production may be required. But endeavours to maintain the existing pattern of productive capacity are more frequently due to an unwillingness to allow foreign competition to eliminate domestic high cost producers than to prevent casualties during a depression. One of the greatest defects of production control schemes in the past has been that they have tended to restrict the output of the low-cost producer as much as or more than the high-cost producer. It does not fall within our terms of reference to attempt to elaborate an ideal system for control or adaptation of production; but one criterion for judging all such schemes must be the success with which they gradually replace the high-cost by the low-cost producer.

Frequently the object of production control schemes is to make primary production rather than price respond to variations in demand, thus rendering it more similar to manufacturing industry. Such a shift of the impact of depressions from price to production would, however, not always be advantageous; a farmer may prefer a temporary loss of money income to an interruption of the normal rotation of crops. It would be advantageous when the demand was very inelastic. When, for example, a 5 per cent fall in demand would, if supply remained unchanged, cause a 50 per cent fall in price, a small reduction in output—of the order of 5 per cent—would be the lesser evil for the producer. Production control would not altogether prevent a reduction in income unless carried far enough to raise the price above the previous level, but it would go a long way to limit the extent of such a reduction. When the supply is also inelastic, as is the case with so many agricultural products, then the grounds for imposing a production control scheme are stronger. But it remains true that owing

to the enormous number of agricultural producers and the manner in which they are necessarily spread over the land surface of the world, it is far more difficult to make production control schemes effective for agriculture than for mining, where supply naturally responds much better to price.

In this and the two preceding chapters we have considered policies to check or counter the spread of depressions from the areas in which they would seem to be endemic, and in earlier chapters policies to check or counter depressions in these areas themselves. It remains for us to draw the threads of our argument together and to indicate the means by which the various policies we have outlined, both national and international, may be co-ordinated.

CHAPTER XX

INTERNATIONAL ADMINISTRATION AND CO-ORDINATION OF CONTRA-CYCLICAL POLICIES

1. INTRODUCTION

With this chapter we conclude the general thesis contained in Part II of our Report, dealing with the problem of economic stability after the transition from a war to a peace economy. In the first six chapters, comprising Section I of this Part, we have outlined the structural features of our economy which tend to make it vulnerable to the broad sweep of economic forces and the nature of the forces that lead to cumulative processes of expansion and contraction. We have indicated the strategic role of investment in the initiation of these processes, the manner in which the forces, once generated, spread from area to area and the susceptibility of the producers of primary products to them. We have shown also the complexity of the conditions that result when these general forces impinge on the widely varied instruments of production, consumption, investment and exchange which comprise the economic organization of modern societies. In Section II we have discussed, for each sector of the economy, and for the major classes of situation that are likely to arise, the character of the contra-cyclical policies that are appropriate, their relative advantages and disadvantages, and the pitfalls that must be avoided in their execution. We append a summary of our views on policy in Chapter XXI. Throughout we have tried to emphasize the serious nature of the task, the fact that there is no single simple solution, no panacea waiting to be applied.

We do not, however, feel that the problem is insoluble. We have indicated in this Report the many different ways in which public policies and public decisions may affect the flow of business activity, giving impulses that are stabilizing or destabilizing in their influence. What is required most of all is that public authorities, with public backing and support, become thoroughly imbued with the seriousness of the employment problem and take adequate measures, first, to diagnose the particular pattern of economic forces which they face, secondly, to work out a co-ordinated programme designed to deal with this pattern, and, finally to see

to it that these measures are not limited to one or two major actions, but are really applied at each appropriate point at which public policy can influence economic decisions. In this connection we wish to emphasize the fact that the maintenance of economic activity at a high level of employment and of real income per head cannot be achieved by a series of *ad hoc* administrative decisions. It requires foresight and long preparation during all phases of the cycle.

We have already stressed earlier in our Report the necessity of advance planning of future public works; we would like now to stress the necessity of maintaining sound and flexible conditions during periods of prosperity so that measures to deal with depressions are complicated as little as possible by the simultaneous need for major structural adaptations of the economic apparatus. The widespread collapse of financial institutions which so frequently occurs in depressions does not usually arise solely because of deflation. It reflects also in most cases the presence of over-extended positions that could have been avoided during the preceding period of prosperity. The necessity for carrying through widespread shifts in employment during depressions is also frequently the result of a preceding over-expansion of particular industries or of industries in particular localities. Public authorities should keep these factors constantly in mind. They should be particularly aware of the problems of flexibility and mobility and should endeavour during periods of prosperity to avoid the development of situations—such as are imposed inexorably by a war—which necessitate either at once or subsequently widespread shifts in the location or in the occupation of workers.

2. NATIONAL VERSUS INTERNATIONAL APPLICATION OF CONTRA-CYCLICAL POLICIES

We have been conscious when drafting this Report how much space we have devoted to recommendations directed almost wholly to national authorities, though our analysis has demonstrated that fluctuations in business activity leading to booms and depressions show little respect for national boundaries but are essentially international phenomena.

We have felt it necessary, however, to be as explicit as possible regarding the nature of the policies open to individual govern-

ments in the face of the frequently very different circumstances that may present themselves, before considering, as we shall in this chapter, how those policies can best be supplemented by appropriate international machinery or be co-ordinated. It is of the greatest importance that governments should not be handicapped in the application of contra-cyclical policies by the difficulty of obtaining agreement by other countries regarding the application of essential parallel policies. It is no less important that governments should not pursue policies in isolation regardless of their influence on other countries and thus render the successful pursuit of common and effective policies impossible.

Proposals are now under consideration by the United Nations for the establishment of machinery both of a consultative and, in some cases, of a limited executive character. We believe such machinery to be indispensable if policies for maintaining a high and stable level of employment are to be successful, and have indicated in previous chapters the desirability of creating certain additional international agencies of this character. We shall assume, therefore, the existence of such machinery in the argument which follows. But before turning to the use of this proposed machinery we must consider in a little more detail whether and in what conditions a country may be able to maintain high employment by national measures alone.

In its simplest form this question asks, on the one hand, to what extent the economy of a country is inexorably bound up with the world economy, whether it is inevitable that it suffer fluctuations in prosperity and employment arising out of purely external developments or decisions over which it has no control, or whether, on the other hand, it cannot abstract from the experience of the inter-war period and from the further experience of economic mobilization during the war, policies that will permit the maintenance of full employment at home without reference to external developments.

Usually this question has been treated as implying a choice between a liberal, as contrasted with a controlled, economy. It is widely recognized that the success of purely national measures involved the acceptance of a very considerable degree of centralized control over the whole economy and also over the activities of the individual citizens. Considerable attention is being given,

consequently, to an appraisal of the advantages and costs of greater, or greater apparent, economic stability as contrasted with the freedom of action to which many peoples have been accustomed. While this issue is of the greatest importance, we must recognize the fact that it does not necessarily arise; that there is a prior question, namely, whether, even granted the widest measure of state control, all countries would be able to maintain a stable economy on an autarkic basis without a serious reduction in living standards. Our analysis throughout this report has pointed consistently to the crucial importance of foreign investment and foreign trade, particularly trade in prime materials, in the international spread of booms and depressions. These critical factors are neither accidents nor special manifestations of an individualistic organization of society; underlying them are the elemental facts that raw materials and agricultural resources are not evenly scattered over the globe in proportion to population and that many peoples do not have a sufficient margin between their production and their minimum consumption needs to provide solely out of internal saving for the development which they need. The success of Russia is not alone due to the determined will with which that country undertook its task, but was also made possible by the fact that Russia constitutes a continent of her own which is endowed with almost every variety of agricultural resources and raw materials.

The German experience is really beside the point. Germany had continuous and urgent need for foreign materials which she succeeded in getting first on a barter basis, then by forced loans, and later by conquest. At all times her ability to formulate and execute an autonomous internal economic policy was conditioned by her ability to meet these needs. Her ability to do so was exceptionally great owing to the size of her market and the dependence of many smaller states on it; but before she had put it to any final test by the use of her economic power alone she resorted to war. The achievement of continuous full employment within the United Nations during the war is also beside the point. It was made possible by an unlimited demand for war materials which were rapidly destroyed. This demand, which was met largely without consideration of financial or economic implications, involved the greatest

movement of goods and services over national boundaries that the world has ever experienced.

The feasibility of securing internal freedom of action by the development of foreign trade on a bilateral basis rests necessarily on the power—political and military as well as economic—which a country is in a position to employ. Such freedom of action will last only as long as that power permits, and for the vast majority of states possessing no such exceptional power, no choice presents itself. It is our conclusion, therefore, that for most of the countries to which this Report is addressed, the formulation of contra-cyclical economic policies must be made within a frame that is international in scope, unless standards of living are to be seriously reduced.

The Delegation does not wish this conclusion to be interpreted to mean that the peoples of most countries must continue inevitably to be exposed to drastic depressions arising from developments outside their borders for which they are in no way responsible. It suggests rather that the problem of maintaining stability is international as well as national. The ability of most countries to achieve sufficient control of their internal situation to permit the successful application of the most appropriate contra-cyclical policies, in fact, requires international understanding and in some cases international action of five distinct forms. These have emerged at various points in this Report and will be summarized in the remainder of this chapter. They are:

(1) the adoption of more liberal and dynamic commercial and economic policies;

(2) the creation of an international mechanism for the orderly conduct of foreign exchange operations;

(3) the creation of an international institution which will stimulate and encourage the international movement of capital for productive purposes and which will, so far as possible, impart a contra-cyclical character to this movement;

(4) international action for the solution of the problems of primary production; and

(5) the international co-ordination of national policies for maintaining a high and stable level of employment.

The appropriate approach to be made to all these problems is now under discussion by the United Nations. Granted reasonable

success in these discussions, and in the operation of the new institutions and agreements which result, public authorities in the various countries of the world would be in a position, in the view of the Delegation, to pursue with confidence the policies for securing a high and stable level of employment recommended in this Report.

3. INTERNATIONAL ACTION REQUIRED

(a) *Commercial and Economic Policies.*

We noted in Chapter VI that, in a situation characterized by trade restrictions, few countries could avoid adopting restrictive devices, since they had no assurance that the gap in their balance of payments produced by an act of internal expansion would be subsequently closed by the spread of revival to other countries. The danger of economic nationalism and the need for a more effective system of multilateral trade under which the beneficial effects of efforts to raise national standards of living may spread to all countries are, we believe, fully recognized today. In Article VII of the various Mutual Aid Agreements, which have set the tone for all subsequent declarations of policy, an undertaking is made to provide for agreed action "directed to the expansion, by appropriate international and domestic measures, of production, employment, and the exchange and consumption of goods, which are the material foundations of the liberty and welfare of all peoples". At the United Nations Conference on Food and Agriculture held at Hot Springs, Virginia, in the early summer of 1943, the thought underlying this agreement is further elaborated in the following recommendation in which the need for co-ordinated action is stressed:

"1. That the governments and authorities here represented, by virtue of their determination to achieve freedom from want for all people in all lands, affirm the principle of mutual responsibility and co-ordinated action:

(a) To promote the full and most advantageous employment of their own and all other people and a general advance in standards of living, thereby providing for an increase in both production and purchasing power;

(e) To maintain an equilibrium in balances of payments, and to achieve the orderly management of currencies and exchange;

- (f) To improve the methods and reduce the cost of distribution in international trade;
 - (g) As an integral part of this program, to reduce barriers of every kind in international trade and to eliminate all forms of discriminatory restrictions thereon, including inequitable policies in international transportation, as effectively and as rapidly as possible.
2. That these governments and authorities take, individually and in concert, whether by conference or otherwise, all necessary measures, both domestic and international, to secure the application of this principle and the achievement of these objectives." (Final Act, Art. 24.)

The International Labour Conference at its Twenty-Sixth Session held in Philadelphia in 1944 adopted a declaration of aims and purposes in which it recognized the solemn obligation of the International Labour Organisation to further among the nations of the world programmes which would achieve amongst other things a high level of employment and the raising of standards of living. It also suggested certain principles appropriate for inclusion in an international agreement, from which we quote the following:

"The signatory governments

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Recognizing, therefore, their common obligation to foster expanding production and employment on a sound basis, free from disruptive fluctuations, and to ensure that workers and productive resources shall not be allowed to be idle while the needs of large parts of the world remain unsatisfied;

Realizing that the economic life and conditions in each nation are increasingly dependent upon the economic life and conditions of other nations, and that hence the attainment of the above-stated objectives requires increasing collaboration among nations;

Have agreed that:

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Each government recognizes its duty to maintain a high level of employment. Accordingly, all arrangements . . . for economic cooperation . . . should be directed to the expansion of production, employment, and the exchange and consumption of goods and to the liberation of economic activity from unreasonable restrictions."¹

We drew attention in Part I of our Report to the need for an international organ to help governments to devise commercial

¹ International Labour Office, *Official Bulletin*, 1 June 1944, pp. 82 and 85 (Preamble and Article II).

policies conducive to economic stability. In order to render our thought on this subject as complete as possible here it may be desirable to repeat what we said then:

"An international organ might, we believe, help governments to devise commercial policies conducive to economic stability in three different ways:

(a) By studying and analyzing the facts concerning the development of trade, the interdependence of different trading areas, the trade in different groups of commodities, the movements in prices, and the changes in the terms of trade;

(b) By giving advice about means for promoting trade, for clearing blocked channels of trade, about the difficulties arising from sudden changes in production or in the competitive power of different areas, etc.; possibly, in the execution of its advisory functions, participating in trade negotiations between governments in order to watch the effects of proposals submitted during such negotiations on the whole body of trading nations and on the general development of trade;

(c) By mediating, when so requested, in connection with both direct disputes between states, and on such wider issues as the formation of Customs unions.

The primary function of such a body should be advisory. It should analyze and study the facts, prepare careful plans for the promotion of trade between groups of countries or along this or that natural transfer route and endeavour by bringing the parties together, by demonstration of the benefits that would arise, by persuasion, to secure the adoption of its proposals."¹

(b) *Monetary Arrangements.*

The measures required to promote employment and trade and to maintain equilibrium in balances of payment are, as we have seen, manifold. One essential measure, however, is to re-establish a smooth-working international monetary system. Proposals to this end have already been put forward as a result of the recent Conference at Bretton Woods. We are not concerned at this stage with the technical details of these proposals but rather with the purposes lying behind them, which, as defined in the introductory articles of the draft agreement on the International Monetary Fund, show the sequence of thought running through all recent declarations of United Nations policy. We quote by way of illustration three of the six objectives, namely:

"(ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance

¹ *The Transition from War to Peace Economy*, League of Nations, pp. 107-108.

of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.

- (iii) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.
- (iv) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade." (Art. I, Annex A, Final Act.)

The principles of policy which we have outlined in Chapter XVII necessitate the existence of some central international monetary agency. Were each state to form an independent judgment on, for instance, the justification of differentiating against the currency or goods of another country believed to be the cause of a widespread deflationary strain, the whole system of multilateral trade, which we hope to see restored, would be threatened. Indeed, once the automatism of the gold standard has been abandoned there remains no alternative to concerted policies. Concerted policies imply some central monetary agency. But, while such an agency should in our opinion have extremely important functions to perform, it could not be either the sole or the final international authority dealing with co-ordination of policies for maintaining a high level of employment.

(c) *International Investment.*

We have noted in earlier chapters the essential role played by international investment of long-term productive capital in the advancement of world standards of well-being and the highly cyclical nature of this type of investment in the past. We have indicated the policies that should be pursued by governments, investors and borrowers on international account to mitigate the severity of these fluctuations in order to modify their destabilizing effects. We doubt, however, whether these policies alone would be sufficiently powerful to neutralize such fluctuations completely, still less to produce what is really needed, a contra-cyclical movement in the flow of international investment funds. For this we must look to an international agency, capable of taking decisions at the international level, an agency such as the proposed International Bank for Reconstruction and Development. It is proposed

that this Bank, recommendations for which were also formulated at Bretton Woods, undertake to aid in the development of the less industrialized countries of the world. Such basic developmental operations of an international character are analogous in many respects to long-range internal programmes of public works, which, it is now generally agreed, should be executed as far as is practicable so as to exert a contra-cyclical and hence stabilizing influence on business activity. The same reasoning applies to long-term plans for international development and we suggest therefore that one of the major responsibilities of the authorities of the International Bank for Reconstruction and Development should be the timing of its operations to promote a contra-cyclical movement in the flow of international productive investment.

(d) *Stabilization of Primary Production.*

Our analysis throughout this report has emphasized how sharp cyclical fluctuations in the incomes of primary producers play a crucial role in the ebb and flow of prosperity and depression and also how these movements, because of the preponderance of primary materials in international trade, are particularly influential in the international spread of booms and depressions. We have also drawn attention in Chapter XIX to the possibility of mitigating these fluctuations through the management of international buffer stocks. The Delegation regards this as a problem of the highest importance and feels that there is urgent need for the early development of appropriate international plans to deal with it.

(e) *International Co-ordination of Contra-cyclical Policies.*

We have noted earlier in this chapter that the bulk of our detailed recommendations have necessarily been directed to national authorities working within the framework of national powers and responsibilities. We have also indicated that unless these policies are carried on by common agreement and after joint and continuous consultation, there is danger that they will run counter to each other, that one country may tend to spread depression abroad in order to maintain employment at home, that the growing social demand for greater security of employment will result in

measures rather disruptive than cohesive in a world of isolated, pugnacious national units.

Thus, if there is a lack of co-ordination between governments with the result that price levels are at variance with one another, some countries will find themselves unable to compete and, owing to the more rigid cost structures typical of modern economies, will be tempted to resort to trade restrictions which are likely to prove easier to impose than to remove. Restrictions breed restrictions; if others retaliate, the whole effort to maintain active economic conditions may break down. Owing to these restrictions, the consumer, unable to buy on the cheapest market, unable to benefit from the international division of labour, will be forced to pay higher prices for what he buys; real incomes and living standards will be reduced.

If national authorities are to be successful therefore in applying policies of the type we have recommended in this Report, if a more liberal reorientation of commercial policy is to be effective, and if special international agencies with important executive powers are to be set up, there is also need for the creation of some international organ for the co-ordination of contra-cyclical policies. Such a need was in fact recognized in the discussions held at Dumbarton Oaks, when it was suggested that provision should be made for a General Assembly endowed with powers of initiation and co-ordination in economic affairs and for the creation of an Economic and Social Council as part of the proposed framework of the new United Nations organization. It may be well to quote certain of the relevant articles in full:

"V.6. The General Assembly should initiate studies and make recommendations for the purpose of promoting international co-operation in political, economic and social fields and of adjusting situations likely to impair the general welfare.

7. The General Assembly should make recommendations for the co-ordination of the policies of international economic, social and other specialized agencies brought into relation with the Organization in accordance with agreements between such agencies and the Organization.

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IX.A.1. With a view to the creation of conditions of stability and well-being which are necessary for peaceful and friendly relations among nations, the Organization should facilitate solutions of international economic, social and other humanitarian problems and promote re-

spect for human rights and fundamental freedoms. Responsibility for the discharge of this function should be vested in the General Assembly and, under the authority of the General Assembly, in an Economic and Social Council.

2. The various specialized economic, social and other organizations and agencies would have responsibilities in their respective fields as defined in their statutes. Each such organization or agency should be brought into relationship with the Organization on terms to be determined by agreement between the Economic and Social Council and the appropriate authorities of the specialized organization or agency, subject to approval by the General Assembly."

The Dumbarton Oaks plan also recommends that the Economic and Social Council should "set up an economic commission, a social commission, and such other commissions as may be required".

Whatever final form the international organization of the future may take, it should in our opinion provide adequate machinery for the general co-ordination and synchronization of policies of the character we have suggested for the avoidance and mitigation of economic depressions. What is required is a central advisory body of recognized competence meeting at frequent intervals, having a highly trained staff at its disposal, and charged with tasks of:

- (i) studying the policies pursued by different governments affecting economic activity;
- (ii) studying the fluctuations which take place in economic activity locally or universally and analyzing their causes;
- (iii) keeping governments and the general public informed of its findings and making available to governments its views about policies which might be pursued in order to revive or maintain economic activity;
- (iv) arranging when necessary for joint discussions between itself and representatives of governments and of international bodies concerned with economic policy;
- (v) recommending to the appropriate organ of the United Nations joint discussions among governments, when such a course proves advisable, with a view to formulating common policies against the common enemy which depressions constitute.

Effective co-operation among governments would be greatly facilitated were each government to appoint a person of ministerial or comparable rank whose duty it would be to assure that

the recommendations put forward by the international body received prompt and proper consideration by his government.

It will be observed that we have in mind an advisory body—an advisory body, however, which should be enabled to keep in constant touch with governments and to formulate agreed opinions for consideration by those on whom final political responsibility rests.

It would, we feel, be preferable to compose this body of persons selected by the contemplated Economic and Social Council, rather than by governments. But it is important that it should always have amongst its members nationals of the countries that constitute the great import markets which exercise the greatest influence on economic activity, and, moreover, persons whose views will carry weight not only about, for instance, technical monetary questions, but also about broad issues of commercial policy, of labour policy, of agricultural policy, of public finance. If appointed in the manner we have suggested, it would no doubt report formally to the contemplated Economic and Social Council and through it to the Assembly. But occasions are likely to arise in which urgent action is required, and for this reason we feel that it should be empowered:

- (i) to make its reports public or submit them to governments, when it felt such a course was desirable, prior to their consideration by the body to which it would normally report—a procedure which is in conformity with existing international practice;
- (ii) to invite governments of countries whose policies on any occasion are likely to prove of vital importance, to send representatives to participate in its discussions, with a view to formulating with them an agreed advisory opinion.

At the same time this body should, of course, keep in close touch with all specialized international agencies dealing with economic questions whose action may have an effect on economic activity, with a view to securing a general co-ordination of policy, and will no doubt derive much of its information from these specialized agencies. But this information will require careful centralization and co-ordination with that obtained directly from governments, and for this purpose it is important that the central international

organization should have a fully equipped statistical and analytical service at its disposition.

4. THE NEED FOR COMPARABLE STATISTICAL INFORMATION

It is indeed clear that for the execution of the various policies we have suggested, this international body, these specialized international agencies and governments will need to keep a constant and alert watch on economic developments. To aid them in this task they will require full quantitative information about the ups and downs of business activity, about changes in demand, in supply and in the factors of supply throughout the world. We have already referred to the importance of figures relating to national income and to international balances of payments. The former should not simply give changes in total income, but should provide an analysis of the constituent parts of aggregate expenditure of the type which has been employed throughout this report. In this connection we would remark that it would prove of great value if international figures based on national returns could be calculated so as to afford a general picture of the major classes of income production and expenditure. The latter should be as complete as possible, and the League of Nations has already done much to improve their international comparability. But these are only two out of a long list of classes of statistics which governments must provide to guide both themselves and the business world. We shall not attempt to compile such a list here. But we recommend that a general plan should be drawn up for the compilation of national economic and financial statistics essential for the planning and execution of anti-depression policies; this and the formulation of methodological principles to assure international comparability are tasks of urgent importance. The Committee of Statistical Experts set up under the Statistical Convention of 1928¹ together with the statistical agencies of the International Labour Organisation constitutes the necessary machinery, and a series of recommendations regarding methodology have indeed already been put forward by these bodies, which were being constantly more widely applied before the war.

¹ International Convention Relating to Economic Statistics, signed at Geneva on December 14, 1928: cf. *International Conference Relating to Economic Statistics* (League of Nations, 1928. II. 52).

We insist on the need for comparability because national statistics alone are not enough. It is equally important that the national information should be internationally collated and coordinated and be placed at the disposition of the international body charged with anti-depression policy, of national governments and of the business world.

5. FINAL OBSERVATIONS

Just as we are compelled to choose between the automatism of the gold standard and concerted monetary policy, so we must choose today between economic *laissez faire* and concerted anti-depression policy. Nothing could be more dangerous, nor more untrue, than to assume that the maintenance of the fullest possible measure of employment can be left to each government acting in isolated independence. All will be affected by the success or failure of all others. All must co-operate in their attempts to attain the end on which we believe all agree. Even granted such co-operation, success will not be achieved lightly or rapidly. There will be many experiments, many disappointments and failures. But we believe that it is along the lines of policy we have suggested that there lie the greatest chances of success, granted co-operation. Failing co-operation there can be no success.

CHAPTER XXI

SUMMARY AND CONCLUSIONS

1. Depressions may have many causes. They vary in nature, and may require the adoption of different policies on different occasions. There is no single simple remedy or specific. Moreover, they are international phenomena, or national phenomena spreading from one country to another, and we have had to consider the influence of policies adopted in one country upon economic activity in another. We should have failed wholly in our purpose had we put forward proposals which might reduce unemployment in one area only at the cost of increasing unemployment elsewhere. The complexity of the problem assigned to us has compelled us to deal at considerable length with our terms of reference and we have thought it useful therefore to add a summary of our major findings and recommendations. We would urge, however, that this summary should be read with constant reference to the fuller explanations and various qualifications contained in the earlier chapters of this Report.

2. In the first Section of Part II of this Report¹ we give a general description of the nature of depressions and the manner in which they spread from country to country. It is not perhaps necessary to summarize this descriptive material here, and we will therefore confine ourselves to mentioning one or two crucial facts.

3. General depressions would seem to result mainly from fluctuations in investment and employment in industrial countries. As we indicated in Part I of our Report, therefore, the great industrial countries of the world are under a special obligation to adopt the constructive measures of major importance required to secure economic stability and to accelerate economic development.²

4. In any industrial country the level of employment depends on the amount of expenditure. If insufficient is spent to buy the whole output that can be produced, some people will be unem-

¹ Part I of our Report is *The Transition from War to Peace Economy: Report of the Delegation on Economic Depressions, Part I* (League of Nations, 1943. II. A. 3), published in April 1943; Part II, the present Report, is divided into two Sections—Section I, "The Nature of Depressions", and Section II, "Anti-depression Policies". The present Chapter relates to Part II.

² *The Transition from War to Peace Economy* (League of Nations), page 16.

ployed. In any economy where people save part of their incomes, the maintenance of demand and consequently of employment depends on an equivalent amount of expenditure being directed to investment. In advanced industrial countries where the saving-investment process is very important, the maintenance of demand is likely to prove especially difficult. Depressions arise in those countries mainly owing to the fact that changes in investment plans do not always synchronize with decisions to save. When savings outrun investment they go to waste and unemployment is caused.

5. If demand falls off in investment industries, unemployment will be caused and can only be overcome if that demand is made good or some other demand takes its place.

6. Aggregate demand may conveniently be classified under:

- (i) private consumption;
- (ii) private investment;
- (iii) public expenditure on current goods and services;
- (iv) public investment expenditure; and
- (v) net foreign investment.

7. The object of anti-depression policy must be to maintain aggregate demand. Any one of these constituents of aggregate demand can theoretically make good a falling off in any other. But in practice, as productive resources are not completely mobile—labour, for instance, cannot move immediately from one occupation or skill to another—it may prove impossible to effect such compensation rapidly. This fact constitutes one of the main difficulties in framing policies to offset depressions.

8. We considered in Chapters IX to XX policies which might be adopted to maintain demand against the influence of factors likely to lead to depression, or to revive demand. It is in our opinion an obligation of governments both to pursue such policies and to co-ordinate their policies internationally so that the policy of no country acts to the detriment of others.

9. Before turning to a consideration of these policies, however, we wish to emphasize here that governments would be well advised to consider at all times how sensitive their whole economic structure is to forces contributing to depressions, and whether measures could not be adopted to render it more resistant. Thus as con-

sumers' demand for goods of primary necessity is exceptionally stable, all measures to raise the general standard of living of the lower income groups and to enable them to purchase such necessities will contribute to stability. Similarly, all measures tending to increase the mobility of labour and promote the adaptability of machinery, agriculture, etc., will both lessen the risk of depression and render anti-depression measures more effective.

1. PRIVATE CONSUMPTION EXPENDITURE (*Chapter IX*)

(a) *Non-durable Goods (Chapter IX, 1-6)*

10. Expenditure by private individuals on non-durable consumption goods and on services constitutes by far the largest part of aggregate final expenditure. Though relatively stable, this expenditure is subject to fluctuations which are quantitatively great.

11. All measures of social insurance, but especially unemployment insurance, contribute to the stability of consumers' demand, and hence to the stability of the whole economy. This contribution might be enhanced by reducing payments by employers and employed on account of unemployment insurance when unemployment is high and increasing them when unemployment is low.

12. Private consumption may be stimulated or upheld by reducing tax rates as well as social insurance premia when unemployment threatens.

13. Wages constitute the major part of consumers' demand in industrial countries, and the question whether rigidity of wage rates is a stabilizing influence is, therefore, one of major importance. Our broad conclusion is that whatever changes may be made in individual wage rates, the total wage bill, aggregate labour income, should as far as possible be kept stable in a depression. A general wage increase would raise costs without necessarily increasing purchasing power and a general reduction of wages would reduce aggregate purchasing power and therefore intensify, at least for awhile, the deflationary spiral. But this does not mean that particular wage rates which are out of line should never be reduced, particularly if there are sound grounds for expecting that employment will increase in those industries in which reductions are made or that a decline in employment can be prevented by this means.

14. The fact that consumers' expenditure is more stable than investment implies that countries in which a large proportion of expenditure is devoted to consumption (especially of non-durable goods) are likely to be more stable than those in which the proportion is smaller. Consequently, measures intended to render the distribution of income more equal are likely to have a stabilizing effect, but they may, if they result in very highly geared taxation, tend to check economic progress. In so far as possible, therefore, it is important to endeavour to promote greater equality in the distribution of income by increasing the productivity or the purchasing power of the lower-income groups rather than by fiscal measures alone. We have in mind policies designed to bring about an improvement of public health, of economic opportunity, of educational facilities, on the one hand, and the reduction of the prices of goods of primary necessity, whether by lowering tariffs or by bettering methods of production and distribution, on the other.

15. There would be a still greater assurance of stability of demand were the distribution not only of income but of capital more evenly spread than is characteristic of most modern industrial economies today. Governments should therefore make certain that adequate investment facilities are available to the small saver.

(b) *Durable Consumers' Goods* (Chapter IX, 7).

16. Fluctuations in the demand for consumers' durable goods are closely related to the level and distribution of consumers' incomes. Hence, all measures for stabilizing consumers' income as a whole will also help to stabilize the demand for durable consumers' goods. But demand may be affected by those responsible for the manufacture, sale and financing of these durable goods. In countries in which such goods are largely sold on credit, financial institutions may help to stimulate demand during periods of depression by affording more liberal credit conditions, reducing down payments, and increasing the period of amortization. Similarly, they can contract sales during booms through the application of the reverse policy. Manufacturers for their part can contribute towards stability by adjusting prices to demand.

17. Some assistance might be afforded by governments dovetailing their purchases to changes in private demand, though as a

rule the volume of their purchases of durable consumers' goods is relatively small.

2. PRIVATE INVESTMENT (*Chapter X*)

18. It is particularly difficult to revive the demand for investment goods when it is sagging, for that demand is largely dependent on constant increases in the demand for consumers' goods. Thus, if the demand for consumers' goods remains constant, there may be no demand for capital goods except to replace what is worn out. If consumers' demand increases by an amount which cannot be made good with existing equipment, then there will be a sudden demand for new machinery which will almost completely disappear as soon as the total equipment is sufficient to meet this new demand. Therefore, it will be necessary to compensate such falling off by stimulating other constituents of aggregate demand. Nevertheless, action can be taken to stimulate private investment to some extent when that is necessary. Only part of private investment is devoted to the manufacture of machinery required for making other goods; some part renders services directly itself. In most countries building, which is mainly of this nature, constitutes a large proportion of gross investment in capital goods.

(a) *Residential Construction* (*Chapter X, 2*).

(i) *Building Costs* (*Chapter X, 2, a, b*).

19. The main factors determining the level of residential construction are consumers' incomes, the age and distribution of existing houses, population growth and shifts, and building and financing costs. Because of the great durability of houses, capital costs play an extremely important role. Building is therefore more responsive than most other forms of investment to changes in interest rates. Changes in mortgage interest, the period of amortization and the proportion of cost that can be covered by mortgage credit, all exercise an important influence on the volume of building and may be used to check building excesses during booms and to stimulate building when activity falls off. Governments may assist in reducing financial costs where necessary, for instance, by insuring mortgages for home-owners, and by measures designed to make mortgage credit responsive to changes in other interest

rates. But the active co-operation of mortgage banks, building societies, etc., will in all cases be required.

20. Other building costs may prove equally or more important. The most favourable financial conditions, the most active demand may be rendered nugatory by monopolistic prices or wage rates. When monopoly threatens to prevent revival it is incumbent on governments to take measures to break it down.

(ii) *Dovetailing Public Construction* (Chapter X, 2, c).

21. In certain countries governments may exercise an important stabilizing influence by dovetailing public construction to variations in private construction, and we recommend that all public building by central and local authorities should be expressly planned with this end in view. For this purpose it is important that policies should be thought out in advance, and that the central government should exercise sufficient influence over provincial and local authorities to assure that their building programmes contribute to the promotion of stability.

(b) *Industrial Plant and Equipment* (Chapter X, 3).

22. For reasons already given in paragraph eighteen above, it is more difficult to stimulate investment in industrial plant and equipment directly. Such investment will, of course, be favourably affected by any of the measures for stimulating consumption expenditure which we have considered above (paragraphs ten to seventeen).

23. The first essential for securing greater stability is that business men should realize that the adoption of a long-term investment policy is in their own interest. Governments should encourage such long-term planning and help in the framing of such policies by the provision of statistics concerning the size and age-distribution of the existing stock of capital equipment and the volume of current additions to that stock in the various industries, and concerning business conditions in general.

24. Some influence over the rate of investment may be exercised by the monetary authorities varying the rate of interest both to prevent over-expansion when trade is booming and to increase demand when it is waning.

25. Whatever may be the fluctuations in domestic demand for

plant and equipment in industrial countries, there is always an immense untapped potential demand for these goods in less developed areas. If, therefore, capital exports could be given a contra-cyclical pattern, with the aid of government export credit schemes, or public investment institutions such as the proposed International Bank for Reconstruction and Development, this would contribute greatly to the maintenance of a high and stable level of employment in the industries producing these goods. We revert to this point in paragraph forty-five below.

26. In so far as governments are themselves purchasers of machinery and equipment, they should endeavour to give their purchases a contra-cyclical pattern, increasing them in slack times and decreasing them in times of prosperity.

27. In some countries certain forms of taxation have rendered the entrepreneur unwilling to undertake risky investments. When to personal income taxes are added corporation taxes, a form of double taxation is created which, when rates are high, so reduces the prospect of profit as to constitute a serious deterrent to enterprise. Some mitigation of this discouragement to risk-bearing might be offered by permitting for tax purposes the deduction from corporation profits of losses not only in the year in which they occur, but over a series of years. But in addition to this alleviation, fiscal authorities would, in our opinion, be well advised to realize that high corporation taxes may constitute a serious impediment to enterprise.

28. A stimulus to the adoption of new processes could be given by permitting the rapid amortization of capital and full allowance for obsolescence in computing tax liability.

29. Finally, when the price of the capital goods required for the manufacture of machinery and equipment is subject to monopolistic control, which tends to retard business during periods of depression, governments should take steps to break down such monopolies, a result which can in some cases be brought about by tariff reductions.

(c) *Business Stocks* (Chapter X, 4).

30. Stocks tend to be accumulated when a rise in prices is foreseen and to be reduced when prices are expected to fall. As a result, both the upward and downward movements of prices are accen-

tuated. We suggest in paragraphs ninety to ninety-nine below various measures for the stabilization of the prices of raw materials, including the creation of an international buffer stock agency which might, in our opinion, make a very important contribution towards the reduction of price fluctuations within much narrower limits than has characterized them in the past.

31. Wide fluctuations in prices are not infrequently caused by ignorance of the real statistical position. To obviate this danger, governments should obtain and publish at frequent intervals full information with reference to stocks of raw materials held in all hands, and this information for all countries should be collated and published in the form of a series of international tables.

32. Though the influence of interest rates may be slight when wide price movements occur, an attempt might nevertheless be made to check tendencies towards excessive liquidation by easing short-term rates and to check over-accumulation by stiffening rates. It is important, however, in this latter case, that short-term rates should not be raised so high as to cause an all-round increase in interest rates which will lead to a contraction of investment in fields where it has not so far been excessive.

3. THE RESPECTIVE ROLES OF THE GOVERNMENT AND OF THE BUSINESS COMMUNITY (*Chapters IX-X, passim*)

33. It will be seen that the measures we have considered up to this point for stabilizing consumers' demand and private investment depend to a large extent on the foresight and co-operation of the business community itself. Governments can help by creating a balanced economic system, and indeed this is the first essential of all sound anti-depression policies. We have in mind the creation of conditions in which demand is buttressed against the storm by adequate social insurance; in which the basic needs of all classes of people are always satisfied to the extent that productive resources permit; in which the standard of living of persons and families of lower incomes is increased by increasing their efficiency and their opportunities and by affording facilities for the investment of their savings; in which forms of taxation likely seriously to impede enterprise are avoided; in which information is furnished about current economic conditions adequate for the formulation of sound policies by the entrepreneur. The govern-

ment may intervene, moreover, should unemployment occur, with a view to improving the chances of private enterprise or offsetting a fall in private demand. We have mentioned, for instance, the insurance of mortgages, government aid in contra-cyclical foreign lending and the breaking up of monopolistic positions. But in this private sector of the economy it will, in the final analysis, be the aggregate behaviour of the whole group of persons responsible for the conduct of business—employers and employees alike—which will determine the volume of business in any community in which private enterprise is predominant. It is of the utmost importance, therefore, that governments should do everything to maintain confidence, and should explain the purpose and nature of the policies they are themselves pursuing.

4. CREDIT POLICY (*Chapter XI*)

34. Credit policy operates on aggregate expenditure mainly by influencing private investment and the demand for durable consumers' goods. It may, however, have some direct influence on public expenditure and on the demand for non-durable consumers' goods.

35. There is a tendency to attach less importance than twenty years ago to credit policy as a means for relieving depressions or stabilizing business. We doubt whether it is possible to check a depression in a highly industrialized country by credit policy alone. But in less financially developed countries and possibly elsewhere, interest rates may be sufficiently high after the war to allow reductions to exercise a stimulating influence, and in highly developed countries credit conditions may prove important for certain classes of transaction—real estate, stock market, etc. Everywhere it is necessary to create through appropriate credit policies the monetary conditions necessary for the success of more powerful anti-depression measures.

36. The objects of credit policies in depression should be to make credit cheap and abundant and to prevent bank failures and financial panics.

37. During a cyclical upswing general policies of credit restriction should not be applied unless there are signs of a general speculative price rise. Such a general rise of prices is not likely to occur before a high level of employment all round has been

reached. But a speculative boom in some particular market may occur earlier, for instance, a stock exchange or real estate boom. In such circumstances selective policies of credit control are preferable to a general contraction of credit.

5. PUBLIC EXPENDITURE AND FISCAL POLICY (Chapter XII)

38. Government expenditure may create employment in the same way as private expenditure, and private expenditure itself can be influenced by the level of government expenditure. When public revenues constitute 20-30 per cent or more of national income it is impossible to achieve budgetary equilibrium on an annual basis without seriously accentuating the cyclical instability of business. In the past national budgets have frequently been forced into deficit when economic activity was low; and debt redemption has been accelerated when economic activity was high. In this way public finance has helped to maintain demand by the monies paid out in bad times, and to curtail it in good times. Before the present war certain governments therefore adopted a policy of balancing their ordinary budget, not each year, but over a series of years. We advocate this policy and suggest that governments would be well advised to increase greatly their emphasis on:

(a) expenditure policies that provide, so far as is practicable, for the concentration of public investment expenditure in periods of depression,

(b) seeking to counteract fluctuations in private spending by budgeting for deficits when such spending is abnormally low and for surpluses when it is abnormally high,

(c) taxes the yields of which vary readily with fluctuations in business activity so that they have a minimum de-stabilizing effect.

39. It is, in our opinion, of the utmost importance that governments should plan their public finances in a contra-cyclical fashion, paying out more than they receive in taxes when private expenditure contracts and receiving more than they pay out when it expands. Such a policy need not lead to any greater national debt than would be incurred under the system of annual balancing of the budget. It may be applied in various ways.

40. Public authorities could and in our opinion should vary their public works expenditure in a contra-cyclical way, checking it when private investment is high and expanding it when private investment is low. This policy will have its maximum effect if it is conducted simultaneously not only by the central government but by all local and provincial governments. It requires, therefore, a central influence over the capital expenditure of local and provincial authorities. It requires in addition the preparation of a general plan of public works carefully elaborated in advance.

41. Contra-cyclical changes in the government's contribution to aggregate national expenditure may also be effected by cyclical variations in revenues, whether from taxes or from other sources, for instance, the payments on account of unemployment insurance. With a given rate of government expenditure, aggregate national expenditure and employment can be kept up by a fall in the yield of taxes with unchanged rates, by a reduction of rates and by remission of taxes. In fact, the yield of most taxes and other sources of revenue fluctuates cyclically, and this characteristic could be accentuated for the whole tax system by including in that system some taxes of exceptional sensitivity. We discuss at some length in section 4 of Chapter XII the relative advantages and disadvantages of variations in government expenditures and government revenues respectively, reaching the conclusion that it would be inadvisable to rely entirely on one policy to the exclusion of the other.

42. Different types of public expenditure will have different effects on employment. The primary effects will be greater if the money is spent in an industry in which the proportion of wages to total costs is high. But attention should be paid not only to the workers directly employed, but also to those employed indirectly in producing the required raw materials, tools, machinery, consumers' goods for the re-employed workers, etc. Some types of public expenditure also have the effect of giving rise to private investment, especially expenditure designed to facilitate necessary structural adaptation. Thus expenditure on the development of backward areas or urban redevelopment, which paves the way and opens up possibilities for subsequent private investment, will be likely to have a considerable direct effect in promoting investment opportunities.

43. Conditions may arise under which variations in normal public expenditure and revenue will not be sufficient to offset variations in private consumption and investment. In such circumstances the desirability of undertaking additional public works with the express intention of filling the gap in private demand has to be considered. Such expenditure, if undertaken, should be looked upon rather as a lever to raise private investment than as a means for compensating fully and immediately such decline in private investment as has taken place. The argument in favour of additional public works is essentially the same as that in favour of contra-cyclical budgeting. But care must be taken to avoid contracting a volume of public debt which is out of line with the real productivity of the country. Care must be taken, also, to avoid government expansionary policies leading to inflation. In section 8 of Chapter XII we have set out in some detail the limitations as we see them to a compensatory fiscal policy; we have stressed the importance of avoiding the risk that public spending may prevent the necessary cost reductions; and we have urged that governments should explain fully to the public the objects and causes of the policies they pursue. We have no doubt, however, that in the event of a serious falling off in private demand such compensatory policies may be necessary, and when necessary, they should be undertaken with both promptitude and courage. But government spending is only one, if an important, weapon in the whole armoury that may be employed in the fight against depressions and unemployment.

44. We recommend that governments should supplement their annual budget estimates by estimates of national income. These latter estimates should be made in sufficient detail to constitute a real aid to governments in diagnosing the situation, and therefore the type of policy required. Governments, when submitting their estimates to their parliaments, should explain what measures they propose to take, whether fiscal or other, in order to assure a high level of employment.

6. FOREIGN INVESTMENT (*Chapter XIII*)

45. An increase in exports will raise employment if domestic expenditure as a whole remains unchanged. Consequently, foreign lending, by stimulating exports, may prove a valuable anti-depres-

sion instrument for the richer countries. It is likely to present the special advantage of aiding directly exactly those capital-goods industries which are generally the first to be affected by depression. To be most effective it should take a contra-cyclical form, and governments would be well advised to promote lending when business slackens by rendering the terms of their export credit and similar schemes more favourable. Similarly, we recommend that all national or international organs established to promote long-term lending by government guarantees and in particular the proposed International Bank for Reconstruction and Development should bear these considerations in mind. But the pursuit of this policy must not be allowed to cause an interruption of work already initiated on projects financed with foreign capital which require several years for their completion.

46. While foreign lending should be a valuable instrument of policy, a heavy foreign debt may constitute an intolerable burden to debtor countries in times of falling prices. It is preferable, therefore, that whenever possible foreign investment should take the form of equity or direct investment. When this is not possible, elasticity might be afforded in loan contracts by permitting accelerated amortization in periods of activity and a relaxation of amortization when transfer difficulties present themselves. Moreover, the risk of protracted default on loans would be diminished if prior provision were made in loan contracts for trustees elected by the majority of bondholders to act for all in case of default.

47. Whatever the form of foreign lending, the greatest care should be taken to assure that the monies borrowed are expended in such a way as to increase the productive and hence the transfer capacity of the borrower. This object will be promoted if loans are linked, so far as possible, to the purchase of capital goods. By this we do not mean that the goods should necessarily be purchased in the country in which the loans are raised. On the contrary it is obviously desirable that the borrower should be able to purchase in the cheapest market. When loans cannot be linked to specific goods, the best guarantee against the risk of waste is that the borrowing country itself should participate in the capitalization of the project.

48. Owing to the influence of both borrowing and lending on economic activity and on the balance of payments of the countries

concerned, it is important that governments and monetary authorities in both sets of countries should keep themselves constantly informed of the character and volume of all foreign commitments.

7. THE RISK OF INFLATION (*Chapter XIV*)

49. The risk of inflation constitutes one of the greatest difficulties in applying anti-depression policies. The danger presents itself in its most acute form when there is full employment and the demand for labour tends to exhaust available supplies and to lead to wage increases which are not offset by equivalent increases in productivity. Moreover, labour is not uniform or fluid, so that shortages are likely to arise in some industries while there is still unemployment elsewhere. It is therefore important to take all possible steps to promote mobility of labour. Labour mobility will be promoted if wages respond readily to changes in the relative demand for different types of skill, and trade unions should therefore think and act in terms of economic activity as a whole rather than in terms of their own craft or industry only. The government should, for its part, afford all possible facilities to enable workers to acquire new skills and to move to different localities and thus meet changes in demand as they arise.

50. But it is equally important to assure that the mechanism of production, both industrial and agricultural, is easily adaptable to such changes and that entrepreneurs pursue policies intended to expand and not to restrict production. It follows, therefore, that simplification of mechanical processes rendering it easier for labour to move from one type of machine to another will promote mobility, and that no obstruction should be placed in the way of the application of new and simpler productive processes. We recommend that governments should when necessary reconsider their patent laws so as to prevent firms from suppressing or impeding new inventions. The responsibility of the entrepreneurs for promoting mobility is no less than that of the labour leaders. They must be prepared to adapt production rapidly to shifts in demand. They must be willing always to endeavour to broaden the bases of their market by selling more at a lower price rather than less at a higher price when this choice presents itself.

51. In short, a policy for maintaining a high level of employment must be regarded as a community effort in which no par-

ticular economic group should seize upon a specially favourable bargaining position in order to improve its own position at the expense of that of other groups. In order to secure the co-operation of labour in this effort it is essential that governments should give the assurance that their policies are at all times directed towards increasing the income of the masses of the population by preventing a wasteful misapplication of resources, by the promotion of efficiency in production through facilitating the application of scientific and technical developments and by the control of monopolies and monopoly profits.

8. UNEMPLOYMENT IN SPECIAL AREAS AND INDUSTRIES

(Chapter XV)

52. The absence of mobility on the part of labour and other factors of production may lead, as we have seen, on the one hand to inflationary price rises in the later stages of expansion, and on the other hand to unemployment in certain localities or industries. When this type of structural unemployment presents itself it may be necessary for the government to take special measures to adapt the productive apparatus to the changes that have taken place in demand.

53. Partial depressions, however, are less likely to occur and are likely to be less difficult to remedy when business as a whole is active and there is a ready demand for labour which may have been displaced in any industry or locality.

54. When a localized depression occurs in spite of the fact that trade as a whole is active, either or both of two possible solutions may be sought: The first is to encourage the establishment of new industries in the depressed areas; the second is to facilitate the transfer of labour out of the depressed areas. Among the first class of measures may be mentioned government or banking assistance in the provision of credit to new industries, tax remission, the provision of modern factories at moderate rents, etc. Transfer may be facilitated by grants to cover travelling expenses and maintenance, training facilities, unemployment exchanges and similar means. Clearly, the appropriate measures will vary considerably in each case, and we have not attempted, therefore, to lay down any general principle save that when structural rigidity exists governments should take measures as quickly as possible to over-

come it; we have confined ourselves to giving examples of the type of action taken by governments in the past.

9. CHRONIC UNEMPLOYMENT (*Chapter XVI*)

55. In addition to general depressions of a cyclical character, it is conceivable that in very rich industrial states a chronic tendency for savings to exceed investment expenditure and thus go to waste may arise, with the result that there is a permanent deficiency in total expenditure and chronic unemployment. While we are not convinced that this phenomenon has ever presented itself or that it is likely to do so in the foreseeable future, we feel that we should bear the possibility of such chronic unemployment in mind. It may be counteracted by influencing investment directly, by stimulating consumption, or by reducing those savings that tend to go to waste.

56. Private investment may be promoted by any of the means we have suggested in paragraphs eighteen to twenty-nine above, and, in particular, when there is chronic under-investment, by cheap money policies. The government should, we suggest, also endeavour to create new investment opportunities by public development schemes, for instance, the provision of better communications, electric power, etc., or by promoting research which may lead to the manufacture of new consumers' goods, or by reducing costs so as to render such goods available to a larger proportion of the population.

57. Private consumption may be stimulated by the application of the measures to render the distribution of income more equal mentioned in paragraph fourteen above. But in the circumstances under consideration, since there is an excess of savings, there is a stronger case for redistribution of income by fiscal measures than when there is no chronic excess of savings.

58. Prominent amongst the measures to prevent savings going to waste are public works such as those just mentioned in paragraph fifty-six and the improvement of public services. The opportunities for improvement not only in national productive equipment, but also in public education, health and other similar services, is likely to remain, for a very long time indeed, almost inexhaustible.

59. Still less exhaustible will be the foreign demand for de-

velopment. This may be met in part by foreign investment, which, like domestic government expenditure, can be employed to utilize excess savings.

60. Finally, as and if a situation of stagnation appears in mature economies, an increasing proportion of the spare resources released by technical progress should obviously be devoted to increasing leisure, particularly among the more hard-worked sections of the population.

10. INTERNATIONAL MONETARY IMPLICATIONS OF NATIONAL ANTI-DEPRESSION MEASURES (*Chapter XVII*)

61. An individual country endeavouring to maintain a high level of employment may be faced with the necessity of taking steps to counteract deflationary or inflationary influences coming from abroad. Moreover the pursuit of its own domestic policy for maintaining a high level of employment may, if other countries fail to keep in step with it, involve it in balance of payments difficulties. In Chapter XVII we have discussed, therefore, at some length the principles which should guide national policy under these conditions. The subject is difficult, and this chapter requires to be studied with some care. We may, however, summarize our broad conclusions which do not of course relate to the special problems of the transition period, in the following terms:

62. It must be the object of each country to maintain its national income at a level corresponding to the fullest possible employment of its resources, while avoiding inflation. For this reason a fall in foreign demand due to a cyclical depression abroad should (when it proves impossible to overcome that depression by international action) be offset as far as possible by an increase in domestic expenditure.

63. To countries greatly dependent on their export trade and those whose exports are highly specialized, a policy of compensatory expansion may, however, present very real difficulties and only be applicable to a quite limited extent. For such countries international concerted policies for the maintenance of a high level of employment and a smooth-functioning multilateral trading system are indeed indispensable.

64. The policy of compensating for a fall in foreign demand by domestic expansion may increase the discrepancy in the bal-

ance of payments caused originally by the drop in exports. The country concerned should not seek to meet the deficit by restricting imports, for this would only intensify the depression abroad. The deficit should be met in the short-run out of the country's gold and foreign exchange reserves.

65. For this purpose each country must be equipped with international reserves (or borrowing facilities) at least sufficient to meet temporary adverse balances arising from random causes including cyclical fluctuations. Means for providing certain countries with more adequate reserves, proposed at the Bretton Woods Conference, are now under consideration.

66. If the fall in foreign demand is due to more fundamental causes, such as a lasting change in taste or a decline in the competitive position of the country concerned, a policy of compensatory expansion alone may prove inadequate. In this case measures must be applied to adapt the structure of production to the new conditions. Such measures may be directed towards increasing the country's productive efficiency in the old export trades, developing alternative export outlets, or substituting some classes of goods previously imported by domestic products.

67. These measures may have to be accompanied by policies intended to have an immediate influence on the balance of payments. When this need arises recourse should be had to exchange depreciation rather than to import restrictions or exchange control. But recourse to this measure should only be had after consultation with an international monetary authority, if such an authority exists, and there should be no greater depreciation than is required to restore reserves and prevent the deficit from arising again.

68. Balance of payments difficulties may also arise because a country pursues an expansionary policy for maintaining the level of employment at a time of general depression, and other countries do not keep in step. The conclusions of paragraphs sixty-three to sixty-five apply to this case.

69. If the balance of payments difficulties are due to an expansionary policy at home which has reached inflationary proportions, measures should be taken to check, not expand, domestic expenditure, or to remove the specific causes of that inflation.

70. If inflation is allowed to go on for some time, the mere

cessation of inflation will not be sufficient to stop the drain on the country's reserves. Prices at home and abroad will then have got out of line. In such cases an exchange depreciation, though necessary, may be inadequate and the country may have to face the problems of structural adaptation mentioned in paragraph sixty-six, above.

71. If a country is affected by a rise in foreign demand due to inflationary tendencies abroad, it should offset that rise by a fall in domestic expenditure.

72. A persistent balance of payments *surplus* on current account should be corrected by relaxing or removing import restrictions or by increased foreign lending; or, when these measures prove inadequate, by an appreciation of the currency.

73. If the balance of payments surplus is due to deflationary tendencies at home, then clearly the appropriate policy to restore equilibrium is to stimulate domestic activity and maintain the national income.

74. Should the gold and other reserves of a number of countries be threatened with depletion as a result of protracted deflationary influences in any major importing country (or countries) then,

(a) the countries affected may concert with the depressed country in order to work out a method by which it may correct its balance of payments through domestic expansion, relaxation of import restrictions, foreign lending, or currency appreciation. But should these efforts prove unsuccessful,

(b) these countries may be authorized as a last resort by an appropriate authority, if one is set up, to take common measures to check imports from this country.

75. Disequilibrating short-term capital movements should be prevented as far as possible by means of the exchange of information among monetary authorities, the imposition of deterrent conditions by banks, and, if this proves insufficient, as a last resort by direct control. In our view, however, exchange control, even though it may have to be used to check short-term capital movements, should not, after the post-war transition period, be used for the purpose of interfering with transactions on current account, save with the express authorization of an international monetary authority, if one is established.

76. For a smooth-working system of international payments it is necessary for each country to have not only adequate reserves but appropriate exchange rates. By appropriate exchange rates we mean rates which will secure long-run equilibrium in the balances of payments of all countries without exercising a deflationary influence on any one of them. Such exchange rates would be appropriate to a situation in which all countries enjoyed a high level of employment without inflation. It is desirable that the rates of exchange should be fixed not by the uncoordinated action of individual countries but by common agreement.

11. NATIONAL ANTI-DEPRESSION MEASURES IN RAW MATERIAL AND FOOD PRODUCING COUNTRIES (*Chapter XVIII*)

77. Economic depressions in countries producing primary products present certain special problems which require separate consideration. These countries are liable to suffer from very wide fluctuations in the prices of their export products which will affect their whole price structure. These price fluctuations are normally generated by the cyclical movements of national income in industrial countries and consequent sharp variations in their demand for primary products. In the case of agriculture, where aggregate production is not immediately affected by changes in demand, price movements involve roughly proportionate changes in income. The effects of any changes in the prices of mineral products on income tend to be greater because conditions leading to a fall in prices are likely to lead also to a fall in output, and hence a more than proportionate fall in both individual and national income.

78. Owing to the fact that depressions in these raw material and foodstuffs producing countries are mainly generated in the industrial states, the main cure for them must be sought in the various policies discussed in earlier chapters designed to procure stability in industrial states. But industrial states may fail to stabilize their business activity, and we have considered, therefore, what measures may be taken by primary producers themselves to mitigate the impact of disturbances in their foreign balance on their economic life and whether joint measures can be designed between industrial states and primary producers which may help the latter. Among the national measures which we have considered are the following:

(a) Diversification (Chapter XVIII, 3).

79. Countries largely dependent on a small number of export articles which are subject to wide cyclical fluctuations may be compelled, if other measures are not successful, to attempt to diversify their economies by stimulating the production of alternative goods, whether agricultural, mining or industrial. We have already emphasized the importance we attach to governments giving full consideration to the possibility of structural adaptation.

(b) Export Subsidies, Guaranteed Prices and Domestic Government Purchase Schemes (Chapter XVIII, 4).

80. We mention these, as governments have frequently resorted to them in the past. Their object is to uphold the national money income during a depression, either by stimulating exports or by government stock accumulations. Export subsidies, however, are open to serious objection. They constitute a means by which one country endeavours to promote its trade at the expense of others, and involve, therefore, the risk of tempting these others to grant subsidies in their turn or to impose special restrictions against the countries which grant them. In the one case they defeat their own purpose directly and involve governments in useless expenditure; in the other they defeat their own purpose indirectly by leading to the blocking of the channels of trade. In any case, they force down world market prices still further, thus accentuating the depression in other countries.

81. Guaranteed prices are open to the objection that they often result in export subsidies. Even when they do not, they benefit the country adopting them less than would an international buffer stock scheme, under which the producer of primary products would be able to dispose of a part of its surplus stock abroad, that is, to the buffer stock scheme agency, during the period of low prices. Thus national schemes do not, whereas an international scheme would, favourably affect the balance of payments of the country producing primary products. Moreover stock piles accumulated by the government of a single producing country are more likely to stimulate the production of what is already an excess and to grow until they rather threaten than support the market.

(c) Debt Alleviation (Chapter XVIII, 5).

82. A major concern of governments in agricultural countries when prices fall must be to maintain the money income of the farmer. When this cannot be accomplished, debt alleviation may be necessary. It is desirable, therefore, to keep the short-term interest rates for agriculture as flexible as possible. As mortgage banks sell their bonds on the open market, adjustment of the service of long-term agricultural debt must take time, unless the government steps in and re-finances existing debt, covering any loss that may be entailed. We draw attention to measures adopted in some countries to make the rate of amortization and interest vary with variations in the prices of principal crops.

(d) Monetary Stabilization (Chapter XVIII, 6).

83. We have dealt with this question more fully under paragraphs sixty-one to seventy-six above, and are concerned here only with the situation in agricultural and mining countries.

84. Apart from measures to stabilize the income of the producers of export goods, steps may be taken, when the money markets are adequately organized, to prevent secondary fluctuations in domestic credit resulting from variations in the central bank's gold and foreign exchange reserves. Owing to the wide fluctuations in their balance of payments, these countries will require exceptionally large reserves. These reserves must be built up and frozen when prices are rising or exports are large. They will help to maintain imports when prices of export products fall, and their accumulation and freezing will prevent an inflationary expansion of domestic credit. The adoption of such a policy implies the use of open-market operations or some other form of credit control.

85. When the domestic money market is not sufficiently organized for such purposes, a structural problem may present itself, which should receive the immediate attention of the government.

(e) Devaluation (Chapter XVIII, 7).

86. Under the pressure of falling export prices the countries of the class we are discussing here have frequently allowed their currencies to depreciate. The first effect of devaluation is to help to maintain national income in terms of domestic currency, for the exporters will obtain a larger sum in terms of domestic currency

for each unit of quantity sold. At the same time, imports become more expensive, which will afford some stimulation to domestic production.

87. But devaluation is open to a number of objections. First, like subsidies, it is liable to prove contagious. It is a means by which one country may obtain an advantage in its national trade at the expense of others. These others are likely to defend themselves either by pursuing a similar policy or by imposing restrictions on imports. The terms of trade of the producers of primary products will in such cases be rendered still more unfavourable. Moreover, currency depreciation tends to give rise to speculative capital exports.

(f) *Exchange Control* (Chapter XVIII, 8).

88. Open to objection, too, is an alternative to devaluation which was widely adopted in the 'thirties—namely, exchange control, if such control is designed to keep the domestic price level above that of the rest of the world. Equilibrium in price levels can only be restored by prices abroad rising to the level maintained in the country imposing control. Experience has shown that this rarely if ever happens, and that in the end the country is forced to devalue its currency. In these circumstances exchange control is not so much an alternative to devaluation as a delaying action.

89. Our general conclusion is that autonomous action by the exporters of crude products to avert depressions must be of limited efficacy and that a satisfactory solution of their difficulties can only be found in concerted international action.

12. INTERNATIONAL ANTI-DEPRESSION MEASURES FOR
RAW MATERIAL AND FOOD PRODUCING COUNTRIES
(Chapter XIX)

(a) *Buffer Stocks* (Chapter XIX, 1).

90. With a view to preventing short-term cyclical fluctuations in price as distinct from trend movements, we suggest that governments might be well advised to elaborate a plan for the constitution and financing of an international buffer stock agency with the function of purchasing certain crude products when prices tend to fall and selling them when prices tend to rise. Such an agency should be self-supporting.

91. The purpose of such a policy would be to render prices to producers more stable, which would have the effect of maintaining their demand for foreign manufactured goods and hence of maintaining employment in countries exporting such goods.

92. Such an agency would effect its stabilizing influence by offering to buy at some predetermined minimum price and sell at some predetermined maximum price. Price fluctuations would thus be confined within the limits set by these minima and maxima so long, at any rate, as sufficient stocks remained at the disposition of the agency. Should a tendency for stocks to accumulate or to disappear altogether manifest itself, the agency would modify its prices; but its purpose should be to modify its prices only to the extent necessary to adjust production to demand over, for instance, the period of the trade cycle.

93. It is important, in our opinion, that consuming as well as producing countries should participate in any such scheme, both to assure the financial strength of the undertaking, and to promote a transfer of funds from the former to the latter when prices are declining and depression is spreading to producers of crude products through the price mechanism. Moreover their participation is desirable to prevent the scheme being operated in favour of the producers only.

94. The agency should be entitled to raise funds in addition to its initial capital wherever market conditions prove most favourable. As funds are likely to be abundant in exactly those industrial states which are suffering from inactive business conditions, the expenditure of these funds would help to restore the flow of capital from areas in which savings are going to waste to areas in which money income is being reduced in part owing to scarcity of funds.

95. Were such a system established it might prove wise to limit it initially to a few important commodities and, as experience is gained, to extend it over a wider range of goods in order to exercise a greater influence and in order to diminish the risk of causing disturbing shifts in production.

(b) *Production Control* (Chapter XIX, 2).

96. When the trend of prices, as distinct from the cyclical movement, is downward, or when there is a long-run tendency for stocks

to accumulate with the buffer stock agency, supplementary production control schemes are frequently advocated.

97. When the surplus stocks exist on account of the failure of one or more producing countries to adapt their production to the needs of the market, the proper remedy lies in those measures of domestic structural adaptation to which we have referred in paragraphs fifty-two to fifty-four above. But in some cases it may prove easier to effect these adjustments by international agreement.

98. We have confined our recommendations in this connection to insisting on the point that the success of all schemes for international control of production should be judged on the extent to which they ultimately replace the high-cost by the low-cost producer.

99. Our general conclusion, therefore, is that, of the international measures for stabilizing the money income of producers of primary goods, the creation of an international buffer stock agency and the contra-cyclical long-term foreign lending referred to in paragraph forty-five above are likely to prove the most effective. But these measures must be considered in connection with the other international action of a more general nature which we summarize below.

13. INTERNATIONAL ADMINISTRATION AND CO-ORDINATION OF CONTRA-CYCLICAL POLICIES (*Chapter XX*)

100. We have devoted the major part of our Report to national measures because we have thought it desirable to be as explicit as possible regarding the nature of the policies open to individual governments. But depressions are international phenomena and no country can hope to pursue its policies in isolation without seriously impairing its standard of living.

101. Unless national policies are carried out by common agreement and after joint and continuous consultation there is a danger that they will run counter to each other, that one country will tend to spread depression abroad in order to avoid it at home, and that the world will be divided into a number of autarkic pugnacious national units.

102. It is therefore of the utmost importance that national policies for maintaining a high and stable level of employment

should be co-ordinated and that adequate machinery for this co-ordination should be established.

103. We have already indicated, in part at any rate, the international action we recommend. It falls under five heads:

(a) the adoption of more liberal and dynamic commercial and economic policies;

(b) the creation of an international monetary mechanism;

(c) the creation of an international institution which will stimulate and encourage the international movement of capital for productive purposes and which will, so far as possible, impart a contra-cyclical character to this movement;

(d) the creation of a buffer stock agency;

(e) the international co-ordination of national policies for the maintenance of a high and stable level of employment.

104. The need at once for promoting policies to secure a stable but expanding economy throughout the world, for co-ordinating these policies, and for setting up the necessary machinery has been emphasized in many of the declarations of the United Nations—in the Mutual Aid Agreements, at the Hot Springs and at the Bretton Woods Conferences, as also at the Conference of the International Labour Organization at Philadelphia in 1944. It is greatly to be hoped, therefore, that we shall see a co-operative and fruitful effort to overcome the loss and misery which depression involves.

105. We drew attention in Part I of our Report¹ to the need for an international organ which might help governments to devise commercial policies conducive to economic stability in the following ways:

(a) by studying and analyzing the facts concerning the development of trade, the interdependence of different trading areas, the trade in different groups of commodities, the movements in prices, and the changes in the terms of trade;

(b) by giving advice about means for promoting trade, for clearing blocked channels of trade, about the difficulties arising from sudden changes in production or in the competitive power of different areas, etc.; possibly, in the execution of its advisory functions, participating in trade negotiations between governments in order to watch the effects of proposals sub-

¹ *The Transition from War to Peace Economy* (League of Nations), pp. 107-108.

mitted during such negotiations on the whole body of trading nations and on the general development of trade;

(c) by mediating, when so requested, in connection with both direct disputes between states, and on such wider issues as the formation of Customs unions.

106. In paragraphs sixty-one to seventy-six above we have summarized the national monetary policies which we recommended governments should pursue in the face of inflationary or deflationary influences emanating from abroad. These policies necessitate the existence of some central international monetary organ. Proposals to this end have already been put forward as a result of the Conference at Bretton Woods and indeed once the automatism of the gold standard has been abandoned, it is essential to pursue concerted monetary policies designed to facilitate the expansion and balanced growth of international trade, to promote exchange stability and to obviate the need for exchange depreciation and exchange restrictions. Without such concerted policies, countries will either be reluctant to adopt courageous policies for maintaining high levels of employment, or will, owing to the failure of others to do so, be forced to adopt isolationist policies, accentuating depression elsewhere and reducing their own living standards.

107. We have explained our reasons for advocating contra-cyclical foreign lending in paragraph forty-five above, where we recommended that this policy should be pursued not only by governments, but also by international organs established to promote long-term lending by government guarantees. What is required is an international organ with sufficient funds at its disposal and able to adjust its programme of lending contra-cyclically in a manner similar to that which we have suggested governments should pursue in the execution of their public works programmes. The creation of an organ which would be capable of pursuing the policy we recommend, namely, the proposed International Bank for Reconstruction and Development, is already under consideration.

108. The International Buffer Stock Agency, to the need for which we draw the special attention of governments, would have an influence as regards short-term capital movements of a similar character. For when prices were falling and foreign private short

credits were tending to run out, it would purchase commodities from the countries normally borrowers at short-term and sell when markets recovered.

109. By means of these two international agencies, therefore, the flow of foreign funds could be rendered more steady, and international investment might be converted from a cause of instability into an instrument of stability throughout the world.

110. As we have seen, international action will have to cover a number of fields of activity; and national policies for maintaining a high level of employment may run counter to each other unless measures to obviate that danger are adopted. It is essential, therefore, that there should be some organ of a consultative character for the co-ordination of contra-cyclical policies.

111. As a result of the conversations at Dumbarton Oaks, the proposal has been made that there should be a General Assembly which should act as a co-ordinating body and, responsible to it and under its authority, an Economic and Social Council. Whatever final form the international organization of the future may take, it should, in our opinion, provide adequate machinery for the general co-ordination and synchronization of policies designed to avoid and mitigate economic depressions.

112. We recommend for this purpose the appointment of a central advisory body of recognized competence as a part of the general international organization; this body should meet at frequent intervals and be charged with the tasks of:

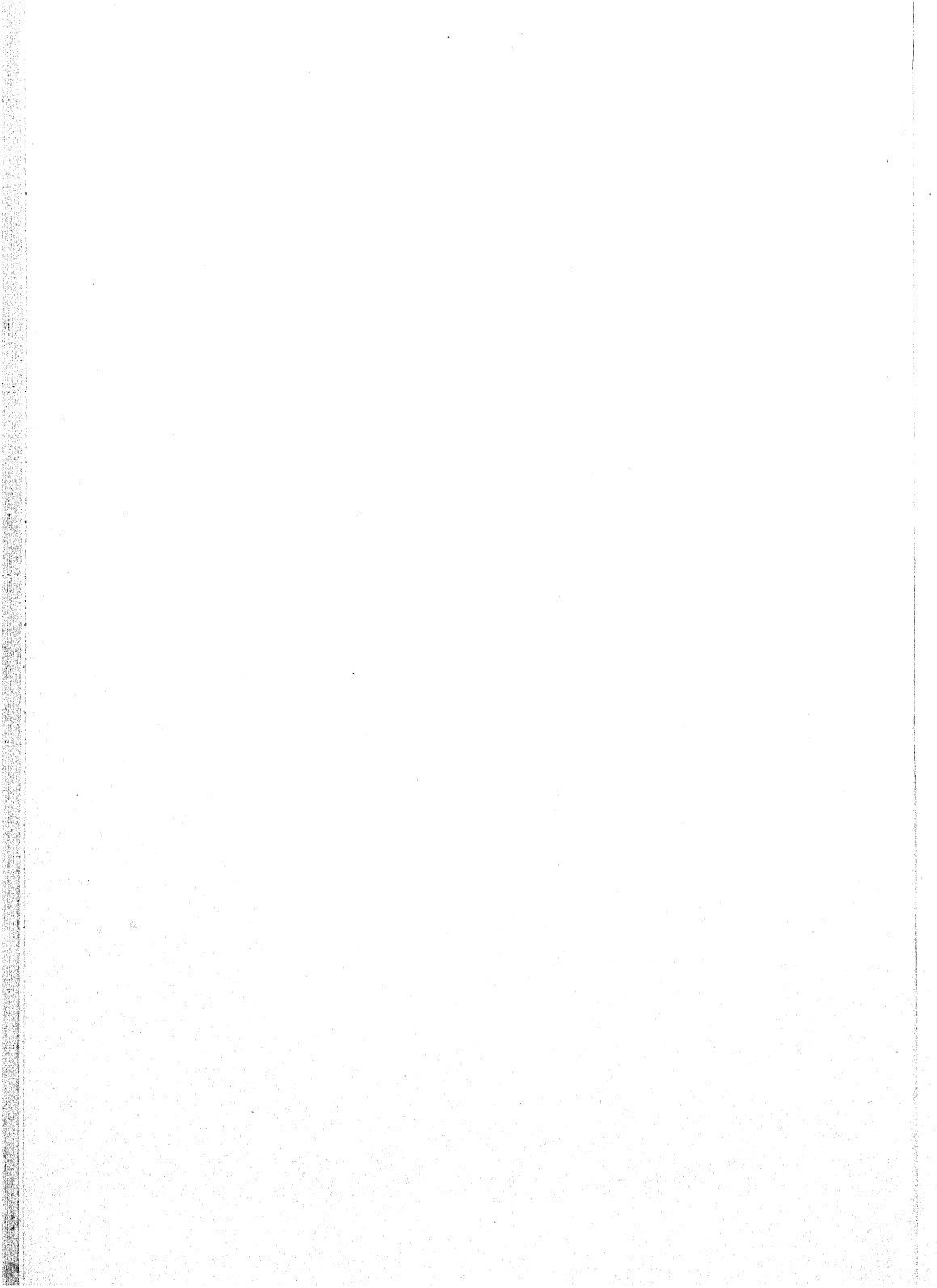
- (i) studying the policies pursued by different governments affecting economic activity;
- (ii) studying the fluctuations which take place in economic activity locally or universally and analyzing their causes;
- (iii) keeping governments and the general public informed concerning its findings and making available to governments its views about policies which might be pursued in order to revive or maintain economic activity;
- (iv) arranging, when necessary, for joint discussions between itself and representatives of governments and of international bodies concerned with economic policy;
- (v) recommending to the appropriate organ of the United Nations joint discussions among governments, when

such a course proves advisable, with a view to formulating common policies against the common enemy which depressions constitute.

113. Effective co-operation among governments would be greatly facilitated if each government were to appoint a person of ministerial or comparable rank whose duty it would be to assure that the recommendations put forward by the international body referred to in the preceding paragraph received prompt and proper consideration by his government.

114. The central advisory body suggested in paragraph one hundred and twelve and all national governments will require for the formulation and application of anti-depression policies, full and accurate information in order to judge the ups and downs of business activity, and changes in demand and supply. It is therefore imperative that governments should take measures to provide such information. This information, moreover, should be internationally comparable and should be centrally co-ordinated, analyzed and published. We recommend that a general plan for the compilation of economic and financial statistics required for the planning and execution of anti-depression policies and general methodological principles to assure international comparability should be drawn up. The Committee of Statistical Experts set up under the Statistical Convention of 1928 together with the statistical agencies of the International Labour Organization constitute the appropriate machinery for this task.

115. Finally, we observe that nothing could be more dangerous nor more untrue than to assume that the maintenance of the fullest possible measure of employment can be left to each government acting in isolated independence. All will be affected by the success or failure of all others; all must co-operate in their attempts to attain the end on which we believe all agree. Even granted such co-operation, success will not be achieved lightly or rapidly.



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(to Part II of Report)

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